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CONFERENCE  
PROCEEDINGS

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Proceedings of the  
6th Annual RAND–China  
Reform Forum Conference

August 28–29, 2003

Preface by Bijian Zheng and Charles Wolf, Jr.

William Overholt, Angang Hu, Edward Leamer,  
Renwei Huang, Benjamin Zycher, Yuanlong Wang,  
K.C. Yeh, Fanzhang Huang, John Despres,  
Gary Hufbauer, Harold Brown, Jisi Wang

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PROJECT AIR FORCE,  
NATIONAL SECURITY RESEARCH DIVISION,  
and ARROYO CENTER

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## PREFACE

The relationship between China and the U.S. is one of the most important relationships in the world today. Since its normalization in the 1970s, the relationship has progressed steadily despite frictions and periodic ups and downs. Leaders of the two countries have viewed this relationship from their strategic perspectives and have focused on their common interests above all. As a result, they have strived to build a constructive and cooperative relationship, which has contributed to prosperity and stability in the Asia-Pacific region and the world. In recent years, in dealing with North Korean nuclear weapons, anti-terrorism, proliferation of weapons of mass destruction, cross-border crimes, and contagious diseases, the U.S. and China have expanded their common interests, strengthened the foundation of cooperation, and further developed their relations. Evidenced by history, Sino-U.S. relations ultimately depend on enhancing understanding between their peoples. In this respect, unofficial exchanges and cooperation play an important role and have their own particular advantages.

In light of these considerations, since 1998, the China Reform Forum (CRF) in Beijing and The RAND Corporation in Santa Monica, California, have jointly organized an annual conference of experts from China and the United States. Each of the six annual conferences held thus far has focused on economic and political-security subjects of mutual concern to China and the United States. The venues of the conferences have alternated between Beijing and Santa Monica, and participants have included policy and business practitioners as well as scholars from both countries.

This volume contains the papers and several of the discussant comments presented at the 6th annual conference held in Santa Monica on August 28-29, 2003.

The direct motivation for initiating this collaboration between the two institutions has been and remains to facilitate the exchange of information, analysis and ideas on the topics addressed in each conference. In the process, the six conferences have sought to enhance mutual understanding among the scholars and policymakers from China and

the United States and, in some instances, to advance consideration of promising policy options that might be pursued.

With this objective in mind, CRF and RAND have developed a cooperative and interactive process for formulating the agendas of each of the conferences held from 1998 through 2003. Following each annual conference, our two institutions have solicited suggestions from conference participants concerning priority research and policy issues to be addressed at the next year's conference. These suggestions have, in turn, been reviewed, culled, and consolidated to shape the subsequent year's agenda. Thereafter each of our two institutions has selected qualified experts from China and the United States--some who are members of the staffs of the two institutions, and some who are associated with other organizations--and have invited them to write the corresponding papers and to serve as discussants. The process has been designed both to provide some degree of continuity in the successive conferences and to bring new participants into them.

In general, the pattern we have followed in shaping and conducting the conference agendas has been to have separate experts from China and from the United States address each specified topic, with an expert from the United States as discussant of each China paper and an expert from China as discussant of each U.S. paper followed by general discussion among all of the conference participants.

This volume of the 2003 *Proceedings of the CRF-RAND Conference* contains the unedited papers presented by experts from both China and the U.S., as well as some of the discussant remarks about these papers. In some instances, discussant remarks were written and these remarks are included in this volume. However, in other instances, discussant comments were not written, but instead were based on notes or "talking points" that are not included in this volume.

These papers were written to stimulate discussion. The views expressed therein are those of the authors, and not necessarily those of RAND, the China Reform Forum, or other organizations with which these individuals are associated.

The 2003 conference included a dinner on August 28, 2003 for the conferees at which the former U.S. Secretary of Defense, Harold Brown,

gave a talk on the North Korean nuclear problem. Dr. Brown's remarks are also included in this volume.

Publication of these Proceedings has been assisted by support from the RAND National Security Research Division, RAND Project AIR FORCE, and RAND Arroyo Center.

This document should be of interest to members of the policy, scholarly, and business communities concerned with economic and security relation between China and the United States.

Bijian Zheng,  
Chairman, China Reform Forum

Charles Wolf, Jr.,  
Senior Economic Adviser and  
Corporate Fellow in  
International Economics, RAND



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## AGENDA

### Conference Sponsors:

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### THURSDAY, AUGUST 28

RAND, North Conference Facility

8:30 a.m. Continental Breakfast

9:00 a.m. Welcome  
Michael Rich, RAND

Opening Remarks

Charles Wolf, RAND  
Wang Jisi, CRF

9:15 a.m. Session One: Economic Issues and Prospects (Moderator:  
Charles Wolf)

*China, Taiwan Economic Outlook*

William Overholt, RAND  
Discussant: Huang Fanzhang, CRF

*China's Economy and SARS*

Hu Angang, Tsinghua University  
Discussant: Charles Wolf, RAND

10: 45 a.m. Break

11:00 a.m. *U.S. Economic Outlook*

Edward Leamer, UCLA - Presented by Benjamin Zycher,  
RAND  
Discussant: Huang Renwei, Shanghai Academy of Social  
Sciences

*Outlook of the U.S. Economy*

Huang Renwei, Shanghai Academy of Social Sciences  
Discussant: Benjamin Zycher, RAND

12:15 p.m. Adjourn

12:20 p.m. Lunch (RAND Patio)

1:45 p.m. Session Two: Economic Issues and Prospects  
(Moderator: Hu Angang)

*China's Financial Sector and the Impact of Multinational  
Corporations*

Wang Yuanlong, Bank of China  
Discussant: Gary Hufbauer, IIE

*China's Financial Sector: Prospects and Repercussions*

K. C. Yeh, RAND  
Discussant: Wang Yuanlong, Bank of China

3:00 p.m. Break

3:15 p.m. China's Industrialization Path in Global Perspective

Huang Fanzhang, Academy of Macroeconomic Research,  
National Development and Reform Commission  
Discussant: John Despres

*Multinational Corporations in China: Impacts on  
Employment, Finance, and Corporate Governance*

Gary Hufbauer, Institute for International Economics  
Discussant: Hu Angang, Tsinghua University

5:00 p.m. Adjourn

6:30 p.m. Cocktails and Dinner- Hotel Casa del Mar, 1910 Ocean Way,  
Santa Monica, Colonnade I

Remarks by Harold Brown, Warburg, Pincus;  
Center for Strategic and International Studies

**FRIDAY, AUGUST 29**

RAND, North Conference Facility

8:30 a.m. Continental Breakfast

9:00 a.m. Session Three: Political and Security Issues (Moderator:  
Wang Jisi, CRF; CASS)

10:30 a.m. Break

11:00 a.m. Roundtable Discussion: Iraq, North Korea, and Regional  
Security

James Dobbins  
Ted Harshberger  
Wang Jisi  
Huang Renwei

12:00 p.m. Adjourn

12:10 p.m. Lunch (RAND Patio)  
Remarks by Jim Dobbins, RAND

1:30 p.m. Resume general discussion and concluding remarks  
(moderator: Charles Wolf)

3:00 p.m. Break

5:00 p.m. Adjourn

6:30 p.m. Dinner at residence of Charles and Theresa Wolf



## CONFERENCE PARTICIPANTS

Richard Baum, UCLA	Huang Renwei, Shanghai Academy of Social Sciences
Harold Brown, Warburg, Pincus; Center for Strategic and International Studies	Gary Hufbauer, Institute for International Economics
Cao Huayin, CRF	David Karl, Pacific Council on International Policy
Gina Despres, Capital Group Companies	Tom Mcnaugher, RAND
John Despres	William Overholt, RAND
James Dobbins, RAND	Michael Rich, RAND
Roy Doumani, Center for Asia Pacific Policy (CAPP)	James Thomson, RAND
Nina Hachigian, RAND	Rachel Swanger, RAND
Ted Harshberger, RAND	Wang Hui, First China Capital, Inc.
James Hodgson, CAPP	Wang Jisi, CRF, Chinese Academy of Social Sciences
Galen Hoskin, Capital Group Companies	Wang Yuanlong, Institute of International Finance, Bank of China
Hu Angang, Tsinghua University, China Reform Forum	Charles Wolf, RAND
Benny Hu, China Development Industrial Bank, CAPP	Andrew Nien-Dzu Yang, Institute of Advanced Policy Studies
Huang Fanzhang, The Academy of Macro-economic Research, Commission of Development and Reform	K.C. Yeh, RAND
	Benjamin Zycher, RAND



**"CHINA'S ECONOMY, BEYOND 2003"**  
**BY WILLIAM H. OVERHOLT**

China's economy has demonstrated extraordinary resilience in the face of a global economic slowdown combined with the SARS tragedy. This resilience results from the successful shift to domestic-led growth prior to the global slowdown and from rising productivity caused by economic reform, rising competition, and high levels of foreign direct investment. Overall, the success results from a disciplined and politically courageous process of reform and opening.

Each phase of Chinese growth and reform presents new challenges. The challenge of the initial phase was to open the economy to trade, to revive farm productivity through an orderly transition to family farms, and to move toward market prices. In the early 1990s the principal challenge was to overcome inflation. In the later 1990s the principal challenge was to get state enterprise (SOE) inefficiency and losses under control. Failure to cope with any of these challenges would have been fatal to China's economic miracle. So far, each challenge has been successfully surmounted. Along the way, major successes have been registered. Growth has been high. Poverty has fallen sharply. Trade has grown rapidly. Foreign direct investment has exceeded all expectations. A dynamic private sector has emerged as a major contributor to growth.

Two recent successes deserve particular mention. First, the shift to domestic-led growth. All of the Asian economic miracles have been driven by exports, and China initially followed this pattern. Japan continues to depend on growth of net exports as virtually its only source of economic growth, despite warnings by foreign economists from the late 1970s onward, and despite official endorsement of the Maekawa Plan in 1986, that only a shift to domestic-led growth could avoid eventual stagnation. China on the other hand not only accepted the imperative of such a shift but also implemented it decisively, beginning at the end of the last decade. The result has been an economy driven by domestic housing, cars, retail consumption, and infrastructure investment. These founts of domestic growth have permitted economic growth of about 8 percent even when net export growth has been negative.

Indeed, China has grown rapidly in 2003 even though the current account balance for the first half of 2003 appears to have gone negative. Such a rapid shift is a remarkable feat.

The second success has been surmounting the economic challenge of SARS. We do not yet know whether SARS will recur; virtually all U.S. experts believe that all coronaviruses are seasonal and that SARS will therefore recur in the autumn. What we do know is that SARS was vanquished as a short-term threat to the economy and the society in the first half of 2003. That threat was very severe, threatening to curtail tourism, trade, investment, education, and virtually all services that involved face to face contact. We know that small private service businesses suffered severely. Despite this, industrial production rose 16.2 percent in the first half of 2003 and exports 28 percent. Retail sales grew just under 8 percent as compared with a 9 percent growth rate for all of 2002. Utilized foreign direct investment rose 34.2 percent to a record \$30.3 billion. While SARS slowed GDP growth to 6.7 percent in the second quarter, from 9.9 percent in the first quarter of 2003, most forecasts are that growth for the year will be well above 7 percent. If SARS recurs, China and the world will be better prepared the next time. Meanwhile the economy's resilience in the face of the SARS challenge is a historic success.

On a third major challenge, WTO, the results are preliminary but highly auspicious. While there are innumerable foreign complaints, and many domestic stresses, following from the first year of WTO implementation (2002), the overall balance appears highly favorable. China has proceeded with WTO implementation, and the domestic consensus has held. In a few key sectors where WTO rules were believed to risk devastating problems, the result has been the opposite. Agricultural incomes, instead of declining, seem to have managed a slight bit of growth. The auto industry was supposed to be devastated by WTO; instead, it created a mass market and a big win for all major participants, including consumers, domestic manufacturers, foreign joint ventures, and importers. Vehicle sales expanded by half in 2002. Transportation sector profits rose 71 percent. Imports increased 77 percent. General Motors' revenues in China rose 325 percent. It is not clear yet, at least to this writer, whether these are typical of the

overall response of the economy to WTO, but these do show that seemingly insuperable problems can be overcome. The auto sector successes clearly do provide a template that other pressured industrial sectors can emulate. Demonstrably, globalization can be good even for those sectors where everyone expected it to be troublesome.

On the foreign side, there will be a deluge of detailed complaints about China's WTO implementation and those are about to become much more vocal. That was inevitable because of the vast educational and organizational tasks required for full implementation. There are many disputes ahead, and much diplomacy as well as concrete action will be required. However, there has not been a single major foreign actor asserting that China has strategically ignored its WTO obligations; this in itself is a preliminary success. The ascent of the WTO hill has just begun, but the early signs are auspicious.

As in the past, China's successes are being achieved by reforms that overcome severe challenges. The challenges for China's new leaders are as daunting as those faced by their predecessors.

One immediate challenge is a combination of foreign pressures and domestic problems created by the currency. The G-7 is bringing pressure on China to revalue its currency. In America's Midwest and South, Japan's Kansai, and Europe's Po Valley, the politics of this issue has become feverish. These foreign pressures are largely based on bad economics. While Japan's deflation is caused overwhelmingly by domestic banking problems and industrial overcapacity, it is more convenient for Japanese political leaders to blame China for their deflation than to undertake the politically painful banking reforms and corporate closures that would allow banks to lend freely and companies to price their goods profitably. While an RMB revaluation would do little to increase U.S. jobs, it is easier with an election looming in 2004 to blame China than to request union and corporate patience in the face of the inevitably slow recovery from bubble overcapacity and from the inexorable consequences of productivity that grows much faster than GDP. While the Euro has simply rebounded to the level that European leaders declared desirable several years ago, it is much easier to blame China than to increase resource mobility and to admit errors in the charter of a central bank that, through excessively high interest rates, is

depressing growth and creating inappropriately strong incentives for investment in euros.

Having said that, China has a problem. As a result of massive purchases of dollars to stabilize the currency, the money supply is expanding excessively and the economy is blinking warning lights. First quarter 2003 GDP growth of 9.9 percent constituted overheating, and that overheating would have become serious had not SARS intervened. By June, foreign exchange reserves had reached \$346.5 billion and M2 money supply was growing at a 20.8 percent annual rate (monthly figure, year on year), which is only consistent with economic stability if the real economy is growing around 15 percent. New loans in the first half of 2003 (1.78 trillion RMB) were nearly as large as new loans for all of 2002 (1.85 trillion RMB). Normally, such growth of money supply would create a threat of inflation, but in an economy where overcapacity is prevalent, the prices of goods are unlikely to inflate.

Instead the surplus money is feeding into such things as bank loans for fixed asset investment, which could lead to an explosion of non-performing loans, and into property, which could lead to a classic Asian property bubble. In fact, signs of such a bubble are already apparent in Shanghai, where property prices rose 15 percent in 2002 and 18 percent in the first seven months of 2003. Medium quality housing there now costs 5,000 to 7,000 yuan per square meter (US\$600 to \$850).<sup>1</sup> Old single-family houses sell for 20,000-50,000 RMB per square meter.<sup>2</sup> These prices are not yet outlandish, but if they keep rising at current rates they will create serious bubbles. Such bubbles eventually pop, and when they do economic miracles can suddenly end; that is what happened in Bangkok, Tokyo, Taipei, and Hong Kong. It would be catastrophic if China followed a similar path. In the past, Beijing has suffered sale price declines of 75 percent and Shanghai has suffered rental price declines of 84 percent, but as the percentage of the

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<sup>1</sup> "New Home prices still on the rise," *Shanghai Daily News*, August 14, 2003, available on the web from English.eastday.com at <http://english.eastday.com/epublish/gb/paper1/995/class000100022/hwz154434.htm>

<sup>2</sup> "Old houses now a hot commodity,: *Shanghai Daily News*, reprinted in English. Eastday.com. 19 August 2003, <http://english.eastday.com/epublish/gb/paper1/998/class000100022/hwz154947.htm>

population who own houses becomes high the social and economic costs of such busts become severe.

To avoid such bubbles, China must either revalue its currency, allow large capital outflows, encourage a large flow of imports in order to run a large current account deficit, or use some combination of reserve requirements and higher interest rates to tighten monetary policy. China must choose some combination of these that fits its own national interests, but it must choose. Otherwise the Tokyo-Taipei crisis of 1990 and the Bangkok-Seoul-Jakarta crisis of 1997-'98 will be followed several years from now by the Beijing-Shanghai crisis of 2005, 2006 or 2007. For the other Asian miracle economies, such a bust has caused the end of the miracle and engendered a period of political weakness.

The G-7 demarche about the currency reflects the frustrations of societies where slow growth has led to falling profits and massive layoffs and rapid productivity growth in relatively flat economies (most true in the U.S.) leads to even more layoffs. Economic recovery should naturally lead to reduction of such political pressures, but such reduction may not come quickly. Jobs recover more slowly than other economic factors, the recovery is largely confined to the U.S. and spotty even there, and the U.S. is headed into an election year. This is not likely to lead to specific action directed at the currency, both because the currency arguments are intellectually weak and because it is difficult to draft specific measures. It could easily evolve into specific measures directed against China's trade, investment and intellectual property practices; in these areas, the intellectual case is stronger and specific measures are easier to draft. The U.S. policy figures with the most global views are trying to keep the international dialogue focused on the currency issue, because currency dialogues do not endanger the trade liberalization process. For this reason it is actually in China's interest for the currency discussions to drag on for some time, and if China takes dramatic measures to open or encourage imports that will further defer the potential threat of protectionist measures from Japan (the leader on this matter), the U.S., and Europe.

The bubble risk is tightly connected to another of China's increasingly urgent challenges, namely the banking system. While

official statistics calculate non-performing loans (excluding those transferred to asset management companies or AMCs) at about one-quarter of GDP, the IMF estimates them (including those transferred to AMCs but not yet resolved) at between one quarter and three quarters of GDP; the lower end of the IMF estimate is included only to be diplomatic. If bubbles are forming, and if a whole range of new steel mills, car factories, and property developments go sour several years, hence, the banking squeeze could become unmanageable.

Just as serious, China's economic growth now depends on successful financing of small, medium and private enterprises that the big state banks don't know how to fund. Moreover, banks' inability to enforce legal judgments on debtors who do not pay means that even highly skilled new banks cannot prudently lend to companies that do not have government backing. So the system is unable to perform the basic function of any market-oriented financial system, namely to allocate resources to their most productive uses. In this respect it is discouraging that the corporate bond market is shrinking; it cannot compete with banks that have vast resources to lend despite their problems.

State enterprise reform has hitherto taken priority over financial reform, on the reasonable argument that the banks cannot be fully reformed until their principal customers, the state enterprises (SOEs), have been reformed. While that decision on priorities has been defensible, a great deal of progress has now been made on SOE reform and the banking problem is becoming both a formidable threat to government finances and a formidable barrier to the financing of the companies that provide China's growth. Future historians writing about the accomplishments of China's new leaders are likely to focus heavily on one of two stories: (a) The new leaders of 2003 implemented revolutionary reforms of the banking system and far-reaching supportive improvements of the legal process, while taking decisive measures to avoid the emergence of financial bubbles. Their decisiveness avoided a banking meltdown and enabled the nation's resources to be allocated much more efficiently. That carried the Chinese economy to a whole new level of growth and development, and it created the vast number of jobs needed for social stability; or (b) The new leaders of 2003 continued very gradual banking reforms and mistook the emergence of bubbles as evidence

of rapid economic progress; in this way they followed the errors of Japanese, Thai and Korean leaders and endangered China's future economic progress and political stability.

The South Korean banking transformation since 1998 may be a useful model for China. The South Korean and Chinese banking and corporate systems shared many characteristics. China chose to give priority to enterprise reform over banking reform, South Korea to banking reform over enterprise reform. The two countries have many lessons to share.

Two generations of Chinese leaders have acted decisively to preempt major economic problems, and that record supports optimism that future historians will be telling story (a). But it is always the job of economists to point out the risks.

If that were not enough, problems, the coming years are likely to see more of a budget squeeze than China has experienced for some years. China went through a terrible budget squeeze in the early and mid-1990s as it lost large revenues from the SOEs and shifted to a more modern system of tax collection. That shift was marvelously successful, and revenues have risen sharply in both absolute terms and as a share of GDP. However, that great wave of success may now give way to another squeeze--at a much higher level of income and competence.

In recent years the government has benefited from a virtuous circle of rapid economic growth, rapidly improved rates of revenue collection, ability to shift costs off budget to the banking system, and ability to neglect basic social services. In addition, suppressed interest rates and accounting contrivances allowed a budget with an opportunity cost deficit of 8 percent of GDP (according to IMF calculations) to look like a deficit of only 3 percent of GDP. This virtuous circle has made budget "miracles" possible, for instance allowing the military budget to grow 17 percent per year for four years without greatly increasing the military's share of the total budget.

Of the five components of the virtuous circle, three are dramatically reversing and becoming vicious circles. Shifting the burdens has reached a limit that risks financial and economic instability; state enterprise losses have been shifted from the SOEs to the banks, then from the banks to AMCs and from AMCs to the central bank. After this, there only one place to shift the deficits: back onto

the central government budget. Similarly, neglect of the basic social services once provided by the communes and state enterprises now risks a whole series of national crises. The government faces massive pension, social security, agriculture, environment and medical problems, along with potentially destabilizing social inequality; these will squeeze the budget for decades.

The most dramatic indication of the emergent realities is how SARS revealed that China's rural medical system, serving 800 million people, had largely evaporated and that this could put the national economy and social stability at risk. Quite aside from SARS, the national death rate from infectious diseases has risen from a little over 1 percent to 2 percent in the past three years--primarily due to tuberculosis, Legionnaire's disease, hepatitis, and other traditional diseases. Although 2 percent sounds like a small number, this increase is frightening. One further component, the ability to suppress interest rates and understate the cost of transferring budget problems to the banks, cannot be sustained indefinitely in an increasingly marketized economy.

I have not attempted to enumerate all of China's successes; such an enumeration would have to mention the increase of its trade, the benefits of increasing competition in sectors like telecommunications, the increasing technological sophistication, and many others. Nor have I sought to analyze all of China's major problems; such an analysis would have to look at demographic issues, environmental issues, agricultural consolidation, and many others. What I have sought to do is to portray the most decisive issues, both the great successes and the great challenges. China is like a man being chased by a tiger. It is very impressive that he runs faster than virtually anyone else in world history; it is also impressive how big the tiger is.

Most other countries facing such a big tiger would get eaten. Indonesia, the Philippines, Argentina, and many others have been eaten by far smaller tigers. What distinguishes China is both economic and political. It has chosen a process of gradual reform and opening that has proved economically correct in several Asian countries. And for 24 years it has demonstrated an ability to form a workable leadership consensus regarding the most important problems, to implement solutions

in the face of enormous political and social stress, and to overcome the stress by delivering large benefits to most of the Chinese people. Effective politics has been the key to good economics.



**"REVIEW AND PROSPECT: CHINA'S ECONOMY IN SARS PERIOD  
AND POST-SARS PERIOD"  
BY ANGANG HU<sup>1</sup>**

The suddenly-arising SARS (Severe Acute Respiratory Syndrome) crisis has influenced deeply China's highly-increasing economy. The quick changes in the short period of several months give us a chance to have a better understanding of China's economy development. In this article, the author will analyze briefly the characteristics and transformations of China's economy after 25 years' reforming and opening-up since 1978, the influence on China's economy by SARS, the reasons why China can keep high growth rate notwithstanding the shock of SARS, and the guideline and direction of China's economy development in post-SARS period.

**I. CHINA'S ECONOMY HAS HIGH POTENTIAL GROWTH RATE**

China's economy has the following characteristics:

Firstly, China is among the countries with highest potential growth rate in the world. Here "potential growth rate" refers to a stable trend of economy growth, reflects the potential product capacity of an economy system, and represents the normal economy growing ability-which is relevant to product factors such as the stock, the level of technology development and economy structure - of a country in certain period of time.

In 1989, the author made a basic conclusion that China entered into a stage of economic taking-off with accelerated industrialization in about 1980, and this stage would last to at least 2020.<sup>2</sup> It was estimated then that China's potential long-term growth rate was 6-7 percent in the period of 1985-2000, and the estimation by foreign researchers was even lower. In fact, China's potential of development is much higher than that estimated by foreign and domestic scholars.

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<sup>2</sup> Angang Hu & Yi Wang, 1989, *Survival and Development: A study of China's Long Term Development*, Beijing, Science Press.

For instance, in *China in 2020* published by the World Bank in 1997, it was admitted that the Bank's estimation in the middle 1980s on China's GDP was only one half of the actual GDP in 1995.<sup>3</sup> Angus Maddison, an expert at the world's economy growth research, classified China into the "super-growth" type, together with South Korea and Taiwan area.<sup>4</sup> According to the author's calculation of GDP (constant price) of the 1978-2002 period, China's potential of economy growth is 9.3 percent, and that of the period of 1978-1997 is 9.5 percent. Based on the three calculation methods of the economic experts of IMF, China's potential of economy growth is 9.2-9.3 percent in the 1979-1989 period, and 9.3-9.5 percent in the 1990-1998 period. This is quite close to the author's calculation.

In the period of 1998-2002, China's actual economic growth rate was 7.7 percent, lower than the long-term potential growth. This shows that in this period China's domestic demands, especially household consumption demands, were insufficient, with a 1.5-1.8 percent output gap coming into being. Because China is still in the stage of accelerating industrialization and urbanization, with a huge domestic market and obvious regional disparity, China's potential growth is still fairly high. Even if estimated conservatively, China's potential growth of economy in the coming 10 years should be about 9 percent.

Secondly, China's economic system has strong self-driving function. Sometimes we call it impetus of self-developing. Economic system is similar to a running car or train, in that it can move by inertia. That is to say, economic system (variable) has self-driving and self-growing capacity, even without impetus or hindrance from the external power or shock. In economics it is called Self-regress Coefficient  $\rho$ . Generally, this coefficient is fluctuating from 0 to 1. The larger  $\rho$  is, the stronger the inertial ability is; and vice versa. According to our calculation of GDP data in the period of 1978-2002, the Self-regress Coefficient  $\rho$  is 0.997, and this is very close to positive number 1. If the economy growth rate of 2002 is 8.0 percent that of this year (2003) should at least be 7.976 percent, given that there is

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<sup>3</sup> World Bank, 1997, *China 2020: Development Challenges in the New Century*, Washington D.C. World Bank.

<sup>4</sup> Angus Maddison, 2003.

not any impetus or hindrance from the outside. China's economy has entered into the expanding period of the fifth economic cycle since 1977, and there exists growth expansion impelled strongly by both from demand side such as investment and from supply side such as industry impelling force. Consequently, economy growth rate of 2003 will have been up to 9-10 percent. However, due to hindrance caused by SARS, the growth expansion that should have appeared will slow down.

Thirdly, China's macro economy is stable, and China's ability to restrain from external shocks has obviously become stronger. We use the coefficient of economic fluctuation to reflect the degree of departure of actual economic growth rate from growth trend (or the mean growth rate). If this coefficient is lower than 25 percent, then it will be regarded as macro-economically stable or non-fluctuating; if higher than 50 percent, it will be regarded as extremely macro-economically instable or acutely fluctuating. The coefficient of economic fluctuation also reflects the ability of an economic system to resist and absorb external shocks, as economic fluctuation is the result of the interaction between external shocks and interior characteristics of an economic system. To put it in another way, economic fluctuation is a responding curve of the economic system to external shocks. The lower the coefficient of economic fluctuation is, the stronger the ability of the system to resist and absorb exterior impacts is and the more stable the system is; contrarily, the weaker the ability of the system to resist and absorb external shocks is, the more instable the system is. According to the author's calculation, the fluctuating coefficient of GDP growth rate of the period of 1953-1978 is 154 percent, representing the tempestuous rise and fall of economic growth, which belongs to the type of acute fluctuation. The coefficient has fallen to 33 percent in the period of 1979-2000 and the coefficient of economic fluctuation has obviously decreased, which belongs to the type of fluctuation. In the period of 1998-2002, China's economy has suffered exterior impacts for many times, such as financial crisis in Asia (1997), catastrophic flood (1998), economic recession and negative trade growth of the world in 2001, and the acute fluctuation of the oil price of the world in 2002, but China has kept stable growth, with the coefficient of economic fluctuation being only 8 percent, which belongs to the type of non-fluctuation.

This is a period during which the coefficient of economic fluctuation is lowest and the macro economy is most stable since the People's Republic of China has been founded. This shows that China's economic system has been greatly improved, the Chinese government's ability to regulate macro economy has been obviously enhanced: under the circumstance of successive exterior impacts, not only high economic growth rate is kept, but also stability of macro economy is maintained.

## **II. HOW DID THE SARS CRISIS START, DETERIORATE AND WEAR AWAY?**

SARS is a crisis with life cycle of development. We can use a curve that reflects the changes of three indexes of SARS to describe it: the first is accumulative number of cases of SARS in the whole country; the second is the number of new cases every three days; the third is the actual accumulative number of cases (referring to accumulative number of cases minus the number of deaths and minus the number of people who are released from hospital). The former index reflects the changes of stock and accumulation, which changes according to an S-curve; the latter two indexes reflect the changes of increment and flow, which changes according to a converse U-curve. We can divide the life cycle of SARS into four phases according to the three curves.

The first phase is the period of symptoms or latency, i.e., the period from the end of 2002 when the first SARS case was found to the period before February 2003 when epidemic situation appeared in Guangdong Province.

The second phase, namely the period of rapid burst or spreading, refers to the period from February 2003 when SARS epidemic situation burst out in Guangdong Province to first half of May 2003 when pinnacle of SARS cases begins, and this is also presented by the rapid increase of accumulated SARS cases. In this period, the biggest number of SARS cases is reported every three days averagely.

The third of phase is the period of peak or alleviation. The number of new cases has begun to decrease since early May 2003. The number of cured SARS patients has begun to increase. The accumulative number of cases has still been increasing. The actual accumulative of SARS cases has been up to the peak and begun to fall. This is a key period of the crisis.

The fourth phase is the period of the recession of the crisis or post-SARS period. The phase has started since June 2003, when the SARS crisis has been effectively controlled: the number of infected people has decreased; the proportion of cured people has increased; the rate of infected and deceased people has decreased; the ability to prevent and cure has greatly improved; the society has regained its normal order; various negative impacts have obviously decreased and gradually disappeared; and the economy has resurged and approached the economic growing potential again.

The above mentioned four phases of SARS crisis is the background of our analysis of the impacts on China's economic growth and industries by the crisis.

### **III. THE IMPACT OF SARS CRISIS IS ANOTHER CHALLENGE TO CHINA'S ECONOMY**

Premier Wen Jiabao, when speaking of the nature of SARS, defines it as "a suddenly-arising catastrophic disaster." In terms of economics, SARS is a temporary external shock to the economic system, directly resulting in the departure of the economic system and important economic variables from the original or normal development track. It belongs to a type of external, unexpected and instant shock or disturbance that arises suddenly, possibly exerting influences on either the economic system itself or variables of the economic system. The response of the economic system to impacts of SARS demonstrates negative influences caused by the crisis. On one hand, the degree of this impact is relevant to the scale, intensity, spreading range and duration of SARS; on the other hand, this shock has bearing on the structural characteristics of the economic system, and different structures of economic systems have different dynamic responses to the same exterior disturbance or shock. For example, when confronting the same shock, strong nations and weak nations have rather different responding degrees. Strong nations have strong ability to resist and absorb shock and disturbance; on the contrary, the ability of weak nations is rather weak.

There are probably three types of economic growth curves when an economic system is affected by the impact of a crisis. The first is V-type curve with rapid decrease and rapid resurgence as well, and it is a

temporary impact (see Figure 1). The second is U-type curve with rapid decrease but slow recovery; this is a short-term impact. The last is L-type curve which has rapid decrease but no sign of recovery, and it is a long-lasting impact.

The impact on China's economic growth by SARS is a typical V-type curve (see Figure 2). It can be divided into several phases. The first is the phase of high growth. From the first quarter of 2002, China has entered into a new stage of economic growth. The growth rate of GDP in this period is as high as 9.9 percent, creating a new record of growth rate in recent 6 years. And it is 2.3 percent higher than that of the same period in last year. Without the hindrance of SARS shock, the economic growth rate of the whole year should have been 9-10 percent.

The second is the phase when the economy decreases due to the SARS impact. For instance, the economic growth rate of April is 8.9 percent (see Table 1), falling 1.0 percent down than that of the first quarter. It is estimated that the GDP growth of the second quarter will be about 6.7 percent, approaching the lowest point. The third is the phase of recovery which begins from July. The fourth phase is from the end of the third quarter to the beginning of the fourth quarter, when the economy will reenter into the stage of high growing. The rate of influence on China's economy by SARS is 0.3-1.0 percent. The economic growth rate of the whole year is 8-9 percent (that of the first half year is 8.2 percent), which gives China the highest rate in the world economy.

If we take a look at different sectors and industries, a more obvious V-type curve can also be found. For example, total passenger traffic service not only decreases in April and May, but also presents a trend of negative increase. This is also true for tourism. Total retail sales of the catering trade sector fall down in April and begin to increase negatively in May. Value-added of industry decreases in April and May, with a comparatively smaller decrease extent (see Table 1). The degree and hysteresis of the impacts by SARS on these sectors is far more serious than that on the economic growth. These sectors begin their recovery early or late in June or July.

In different regions, the economic growth rate also forms a V-type curve. For instance, in Beijing, a seriously-infected area of SARS, the

economic growth rate of the first quarter of 2003 is 12.7 percent, and that of April is 9.9 percent. The growth rate decreases to 4.8 percent in May, and this represents the largest decrease extent in the country. Shanghai's economic growth rate is 12.8 percent in the first quarter, 12.0 percent in April and down to 10.3 percent in May (see Table 1). The degree of decrease is smaller than that of Beijing. These regions will also resurge in June or July.

These data show that influences on China's economic growth by SARS have emerged. The influence on GDP growth rate is limited, while SARS's influence on a few service sectors is enormous or even fatal and its influence on certain regions of China is strong. However, all these could not change the trend of high-speed growth of China's economy. China has survived from challenges of external shock once more.

It deserves special mention that the world's economic growth is still impotent at present, while China is one of countries with highest economic and trade growth. According to the prediction in "The Economic and Social Survey of the World in 2003 of the United Nations," the global economic growth rate in 2003 will be 2.25 percent, only a little higher than that of 2002, i.e., 2 percent; the growth rate of global trade in 2003 will be 4 percent, while that of 2002 is 2 percent. China's role in the world's economic and trade growth is more and more obvious, and China's proportion to the world's total GDP and exports volume has greatly increased (Figure 3).

#### **IV. WHY CHINA IS ABLE TO RESIST THE IMPACTS OF SARS**

Firstly, for China, a country with large population, vast territory and expansive domestic market demands, major factors determinative to its long-term potential economic growth rate are its interior economic system and characteristics thereof, rather than any exterior disturbing factor, which can only affect fluctuation of the economy.

Secondly, China has shown its particular advantages as a large country. China is a country with vast territory. While west China is suffering, east China may be gaining. There are always some regions within the country where the economy is full of vitality. No matter what temporary and local disasters are faced by the country, there is

always enough room for maneuver. When one region suffers from disasters, people from other regions of the country will always assist those people in need.

Thirdly, China has a mature and flexible economy. As principle participants in economic activities, manufacturers, businesspersons, investors and consumers do not passively accept the results when crises come. Instead, they adjust their production, operation, service and consumption modes actively and rapidly. They seek new commercial opportunities and create new commercial modes. Those industries and enterprises suffering from SARS take measures to self-rescue and avoid bankruptcy.

Fourthly, the Chinese government has undertaken effective political and organizational mobilization. On one hand, the government effectively controls SARS epidemic situation, when no anti-SARS vaccine has been developed. On the other hand, it takes a series of measures to minimize negative influences on economy by SARS. For example, the State Council put forward 21 measures in total, including eight economic acts on May 7, six more on May 21, and another five economic development measures on June 4. And various departments of China's central government also worked out about 200 economic measures. There are so many measures set up so timely and intensively, and these measures are coordinated well with each other. This has seldom been seen in the history. These measures have more or less and early or late played good policy effects, and helped China avoid sudden economy decline and recession. These have become effective equipments to keep China's macro-economy stable.

Fifthly, China has quite high potential economic growth rate, strong inertia of self-growth, low economic fluctuation coefficient, and high economic stability. This is the major reason why China is able to resist external shocks and disturbances (including even very serious disturbances) and avoid severe economic landslide.

## **V. THE DIRECTION AND PROSPECT OF CHINA'S DEVELOPMENT IN POST-SARS PERIOD**

If serious explosive relapse does not emerge, China will enter into a period when SARS crisis begins to wear away, namely a post-SARS

period. In the following part, the author will discuss the purposes, principles, prospects and strategies of development in this period.

On June 17, 2003, Premier Wen Jiabao proposed "two important development objectives"- to make efforts to promote not only the material and cultural living standard of the peoples, but also the health level of the peoples. And he also put forward a development principle, i.e., "three adherences all the time": to adhere all the time to (1) the coordinated development of economy and society, (2) the coordinated development of urban and rural areas, and (3) harmonious co-existence and sustainable development between human and nature.

In the author's view, China's new prospects of development in post-SARS period include four basic viewpoints: (1) to establish a new and people-oriented concept of development; (2) to further "the two wheels driving," namely the coordinated development of economy and society; (3) to establish the priority of the people's health as an objective of development; and (4) to emphasize the public sanitation investment in rural areas.

Under the so-called new and people-oriented concept of development, economic growth is not the objective of development, but only the means. Speaking more exactly, growth refers to the level of human development, with the promotion of people's living quality (including health) as a core. Growth is not just to increase per capita GDP. Early concept of development takes material aspects and GDP growth as the center. According to the early concept of development, growth is the very objective, and material investment is the method; to increase investment is to promote growth. The new concept of development is a people-oriented development strategy. The objective of human development is to develop human potentials by enhancing human abilities which have not been given full play. In China, the objective is to satisfy the ever-increasing material, cultural and health needs of more than one billion Chinese people, which firstly includes satisfaction of the most basic living demands of China's total population, especially the poor population, such as food and clothing, employment, education, public sanitation, and housing. This objective also means great exploitation of human resources and continuous improvement of their abilities, in order to make them reach a higher level of human

development and enjoy high-quality living standard and fair public service.

The "two wheels driving" of coordinated development of economy and society means that economic development is the foundation of social progress, and social progress is the objective of economic development; economic development and social progress are the "two wheels driving" of the development of human society. Either is indispensable. They need coordination and cooperation with each other, and synchronous development. If one wheel (economic development) moves faster than the other (social development), it will restrain the pace of development, and social instability will also appear. The development concept of only economic growth without social development or only income growth without health development is a "crippled" concept of development, which lays its emphasis on only one aspect while neglecting the other. Social development will be the central objective of future development. The government should effectively perform its basic functions, and provide public facilities and services to all the people. In the area of income allocation and public service supply, the principle that "fairness enjoys priority, while efficiency should also be given attention to" should be observed. Different from private service, public service is a type of commonplace service, serving the majority of the masses. Only just and fair service is the most effective service. On the contrary, unfair service is inefficient service. The government should increase the proportion of investment in "social software" and decrease that "hardware investment (such as buildings, equipments, and infrastructures)," so as to make the two investments match each other.

According to the "priority objective of health" (namely people's health is the objective of development), to ensure people's health is one of the central objectives of establishing a well-off society with all round, namely, to make China's over one billion people enjoy a more healthy and happy life with longer life-span and higher living quality. In 2010, the objective that all the people are accessible to basic sanitary service should be realized; that is to say, to ensure that everyone can enjoy elementary health care so as to gradually improve the quality of basic public sanitary service. The government's public investment should be used for the people's health. Macro-economy policy

should be beneficial to the improvement of the people's health standard, redefine the government's functioning in the sanitary area, and adjust the direction of sanitary investment, so that good governance in the sanitary area can be realized.

The "emphasis theory" means that it is one important development objective for the country to provide just and fair public sanitary service to rural population that accounts for the largest proportion of China. If the emphasis to establish a well-off society with all round, lies in rural areas, the emphasis of investment in people's health is also in rural areas. Limited public sanitary resources should be put to prevent from and cure of rural residents' infectious diseases, endemic diseases, malnutrition, and women's and children's disease, as well as the supply of elementary health care. With regard to elementary health care in rural areas, the guideline that "prevention has the priority" should be adhered to and the prevention of diseases should be treated preferentially, to reduce the incidence of diseases and cost of treatment. The government should help to establish a medical treatment guarantee system suitable to rural areas in current situation. The situation of "one country, two medical treatment systems" and "national treatment" of peasants should be improved. The dream of several hundred millions of peasants for thousands of years that "diseases can be prevented and cured in early stage" and "the sick can be cured and the weak can be aided" can truly come into reality.

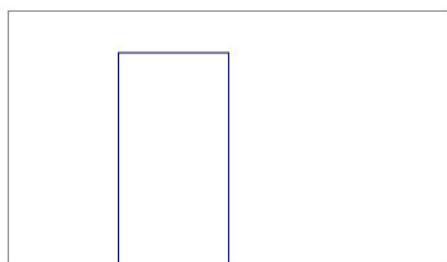
**Table 1**  
**Growth Rate of China's Major Economic Indexes from January to June (%)**

Major Economic Indexes	January to March	April	May	January to June
Gross Domestic Product	9.9	8.9	7	8.2
Beijing GDP	12.7	9.9	4.8	9.6
Shanghai GDP	12.8	12.0	10.3	11.7
Value added of industry	17.2	14.9	13.7	16.2
Government revenue (b)	36.7	15.5	20.7	27.4
Government expenditure (b)	22.3	16.6	26.5	
Total passenger traffic		-6.8		-23.9
By railway		-14.7	-62.5	
By highway		-6.2	-39.9	
By sea		-14.0	-35.1	
By civil aviation		-25.7	-77.9	-50
Investment completed in fixed assets by state- owned and other businesses	27.8	28.9	34.5	31.1
Capital construction		28.0		29.7
Innovation		24.4		
Real asset		31.0		3.4
Total retail sales	9.0	7.7	4.3	8.0
Catering trade		2.1	-15.5	6.4
Total imports and exports	33.0	39.8	33.8	39.0
Exports	25.0	33.5	33.3	34.0
Imports	40.0	46.8	34.4	44.5
General consumer price	0.3	0.6	1.0	0.6
General. retail price		-0.2	0.1	-0.4
Per capita cash income of rural residents	7.5			

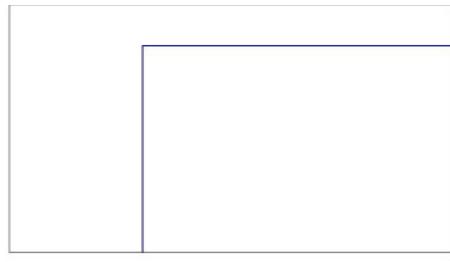
Sources of data: the National Statistical Bureau, *China Monthly, Economic Indicators*, June 20, 2003. July 17, 2003.

<http://www.stats.gov.cn/tjfx/fxbg/1200306200114.htm>

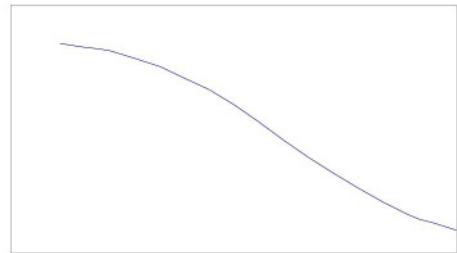
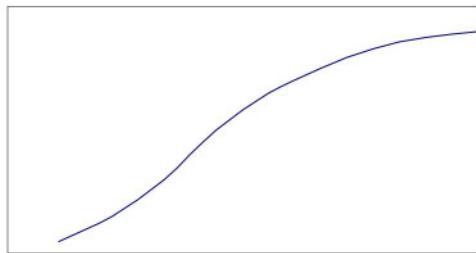
(b) Jin Renqing, China's Xinhua News Agency, Beijing, June 25, 2003



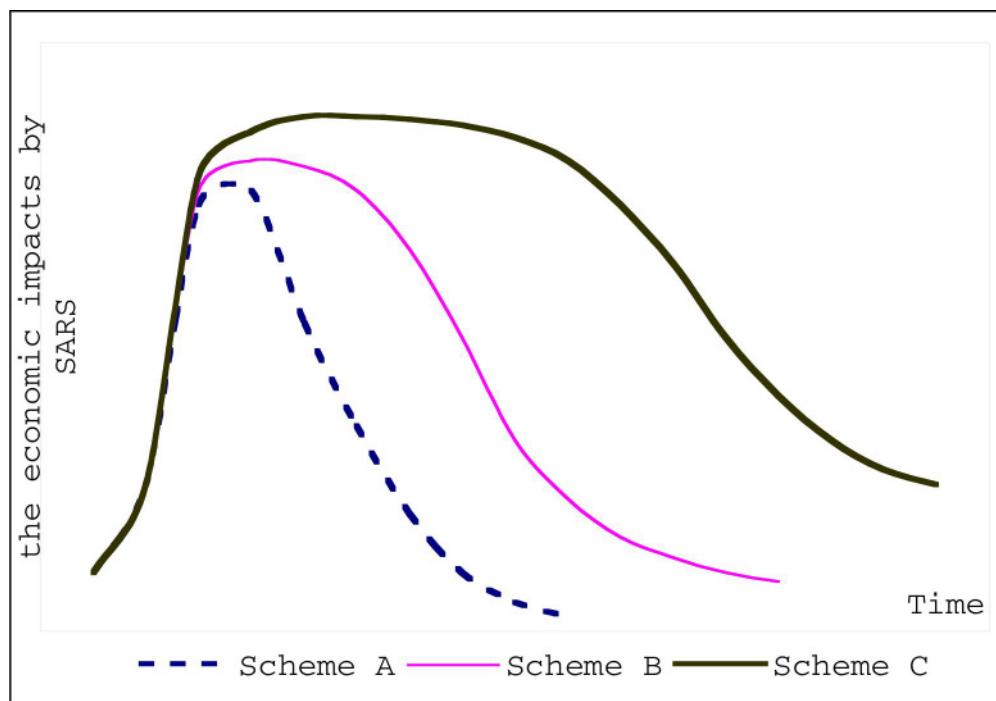
Strengthening & expanding-type of impact



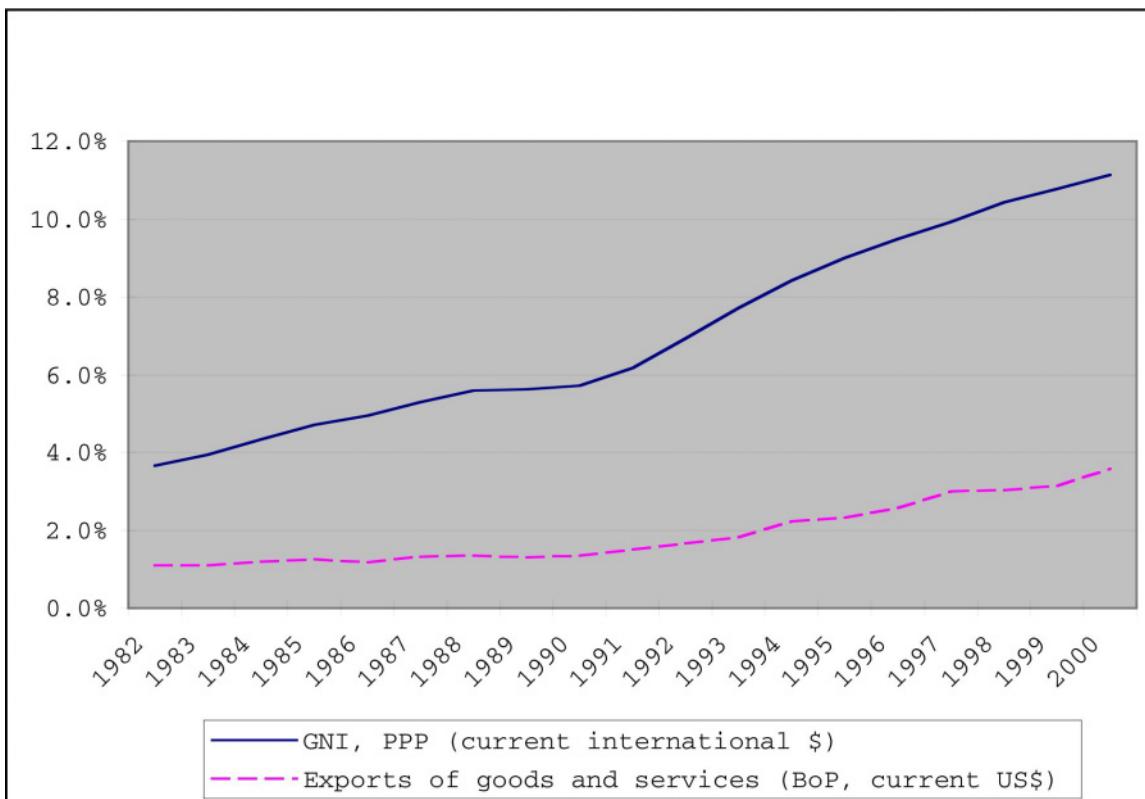
Declining & curtailing-type of impact



**Figure 1--The Type of Function of Impacts**



**Figure 2--The Function Showing the Impact Caused by SARS**



**Figure 3--Rise of China's Share in the World Total (GNI and Exports)**

Source: World Bank, 2002 World Development Indicators, CD-ROM.

COMMENTS ON PROFESSOR ANGANG HU'S "CHINA'S ECONOMY IN THE SARS PERIOD AND POST-SARS PERIOD"  
BY CHARLES WOLF, JR.

Professor Hu is one of China's most knowledgeable and insightful economists, so the strong optimism that his paper reflects warrants serious attention and careful consideration.

He elaborates the grounds for optimism about the outlook for China's economy in terms of three sets of contributing factors: first, factors contributing to China's *potential growth*--namely, continuing capital formation and growth of the economy's capital stock, potential further improvements in human resources, and the increasing scope provided by new technology; second, what he refers to as "*inertial*" factors--namely, the impetus provided by the economy's prior growth whose momentum enhances the prospects for future growth; and third the overall *stability of the macroeconomy*, whose growth has been characterized by a relatively low variance around the sustained growth trajectory of over 8 percent annually during the past two and a half decades.

I share Professor Hu's general optimism, and find the factors that he refers to be both important and persuasive. At the same time, I think there are also reasons for some qualifications and cautionary comments, some of which are reflected in a recently published RAND book entitled *Fault Lines in China's Economic Terrain* (RAND, 2003, Charles Wolf, Jr., K.C. Yeh, Benjamin Zycher, Nicholas Eberstadt, and Sung-Ho Lee). In this study, I and my four co-authors focus on "eight fault lines" or "adversities" that might impede or, conceivably, even reverse China's rapid and sustained growth since 1978. These eight fault lines, which I will not have time to go into in detail in these remarks, are as follows: unemployment, rural poverty and social unrest; corruption; HIV-AIDS and epidemic disease; water resources and pollution; energy consumption and energy prices; financial fragility and the state owned enterprises; possible shrinkage of foreign direct investments; and possibly distracting external conflicts.

Most of these eight fault lines have in one form or another been encountered and successfully managed during the past decades of China's rapid growth. However, each of them might arise again in a more

aggravated form, thereby posing a threat for sustaining China's rapid growth into the future. In our book, we consider various scenarios however unlikely some of them may be and, were they to occur, what their "bottom-line" effects would be on China's otherwise expected and rapid growth. So, the "fault lines" are in the nature of "what-ifs" and thereby suggest reasons for at least some degree of caution in reflecting on the optimism that Professor Hu's paper conveys.

As a general comment, it might be worth noting that despite China's size, diversity, and increasing influence and involvement in global markets, the Chinese economy is likely to experience either or both internal and external shocks to the system. The "fault lines" book describes some of these possible shocks. Other ones may be natural or/and policy-related, and to the extent that they are policy-related they may be due to perverse or mistaken policies that are adopted within China or are adopted by other countries' misguided policies: protectionist trade policies would be one example of the latter.

So, in brief, the case for optimism about China's economy is strong, and yet it is still worthwhile to prepare for some downside contingencies in order to forestall them or, if they occur, to mitigate their impact.

In his comments on the severe acute respiratory syndrome (SARS) and the post-SARS periods, Professor Hu rightly emphasized the speed and pervasiveness of China's recovery from the SARS epidemic. He accounts for this affective response by emphasizing the economy's size, flexibility, and effective "political and organization mobilization" policies, as well as the previously noted attributes of high growth potential, inertial self-growth and underlying economic stability. These are all valid and convincing points. However, it is worth reminding ourselves that the severity and duration of the scare that resulted from SARS would have been reduced if there had been prompt acknowledgement and immediate release of the morbidity data as early as November 2002 when the first cases of SARS were encountered.

Still, there are some puzzling things about the subsequent data after the SARS epidemic had been quelled.

## SARS: Some Observations

- reported cases in China: 5,326, 63% of global (HK 21%, Taiwan, 8%), (WHO, 6/16/03)
  - deaths: China 6.5% of cases (HK 17%, Taiwan 12%, Singapore 15%, Canada 13%)
  - data anomalies
- comparisons with HIV-AIDS:
  - scale and mortality rates  $SARS \leqslant HIV\text{-}AIDS$
  - costs of therapy  $\leqslant HIV\text{-}AIDS$  (unless SARS pandemic)
  - but, SARS contagion  $\geqslant HIV\text{-}AIDS$
- effects on capital formation, FDI, productivity, GDP growth are negative, but magnitudes and duration uncertain

One thing that is puzzling in the above data is that, while China experienced 62 percent of all SARS cases, the mortality rate from these cases in China appears to have been less than half the mortality rates experienced in those other countries (including Hong Kong, Taiwan, Singapore, and Canada) in which there were smaller numbers of SARS cases, but higher mortality rates than in China. What is puzzling is that the other countries with reportedly higher mortality rates than those in China are generally believed to have more highly developed health care systems than those that are presumed to be operational in China!

The reason for calling attention to this possible anomaly is that it's not clear to me that we have yet gotten to the point where the quality of the data relating to health as well as to other aspects of China's economy and society is as reliable as we may hope it will be in the future.

"U.S. ECONOMIC LOOKOUT"  
BY EDWARD LEAMER  
PRESENTED BY BENJAMIN ZYCHER

THE ANDERSON SCHOOL AT UCLA

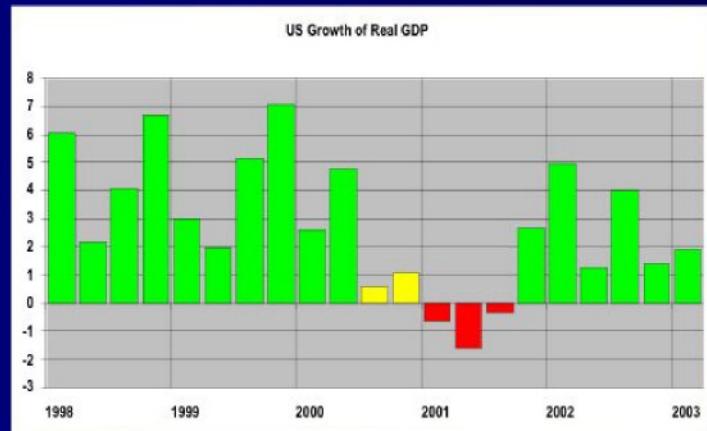


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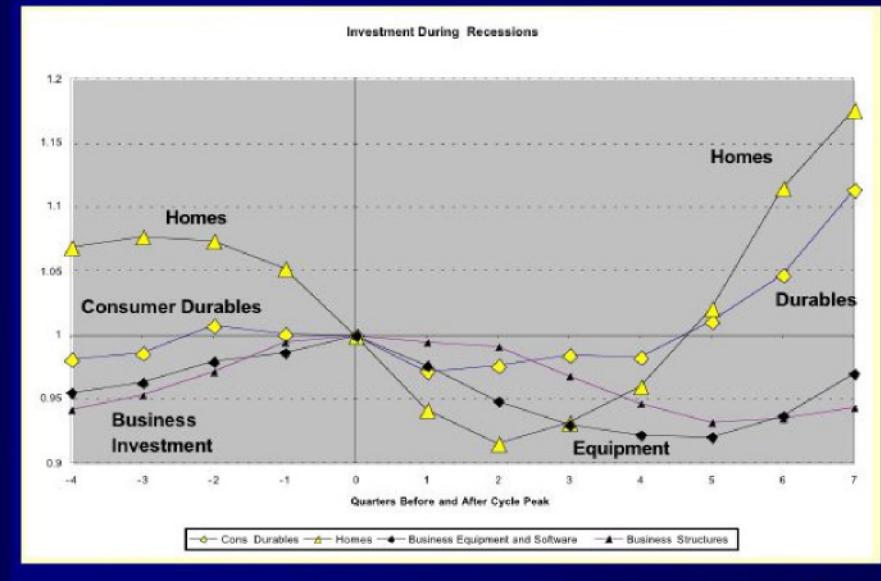
EDWARD E. LEAMER  
Professor of Management, Economics and Statistics

# With Lowered Expectations, 2002 was a good year



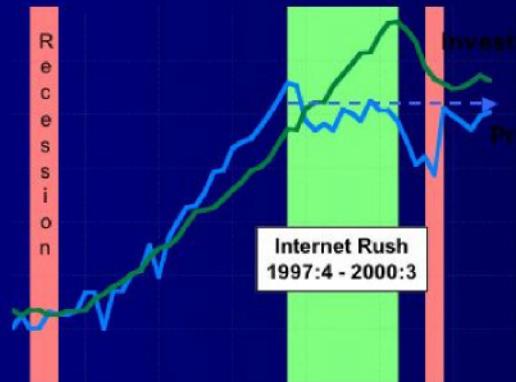
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## Consumer Cycles, Not Business Cycles



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# Corporate Imbalance



Corrected

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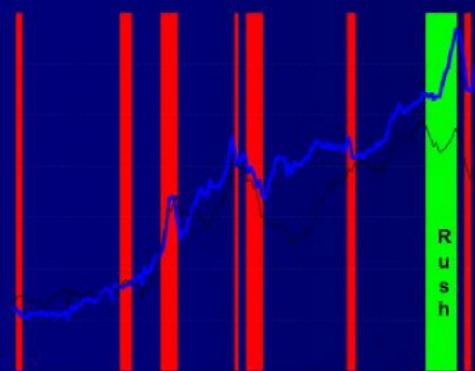
# Consumer Imbalance: Negative Net National Savings



Worsening

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FORECAST

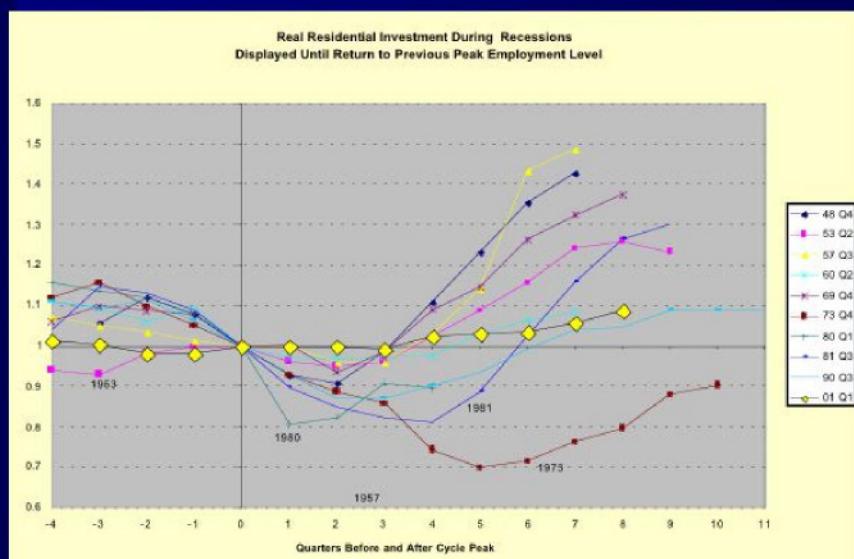
## Global Portfolio Imbalance:



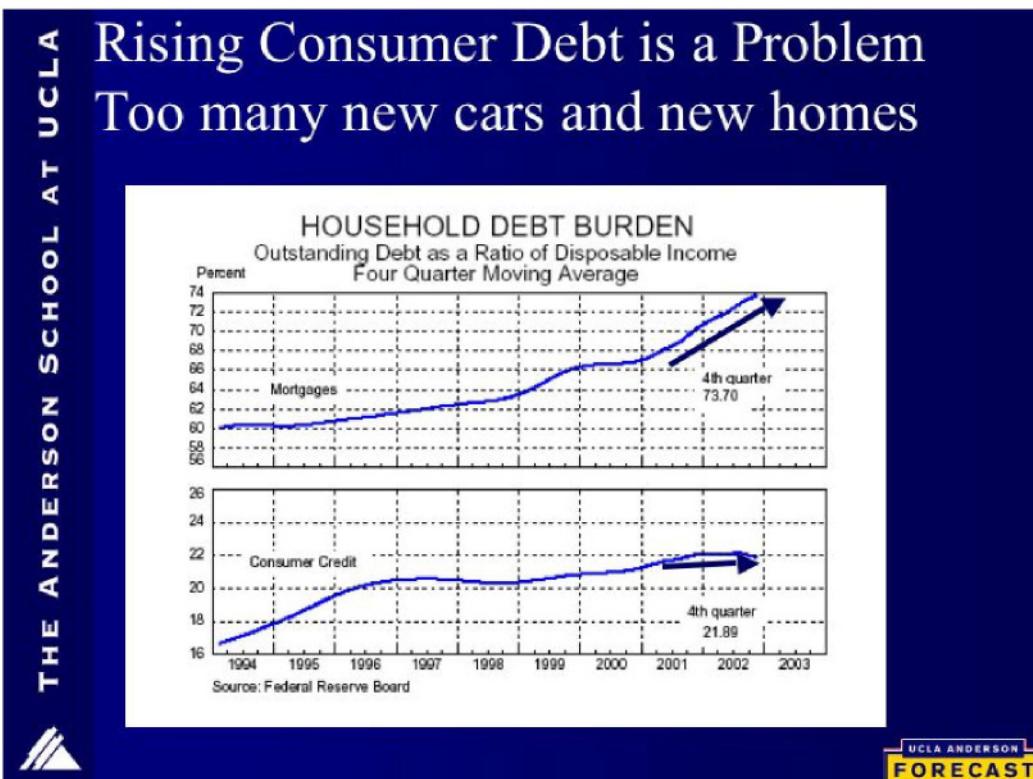
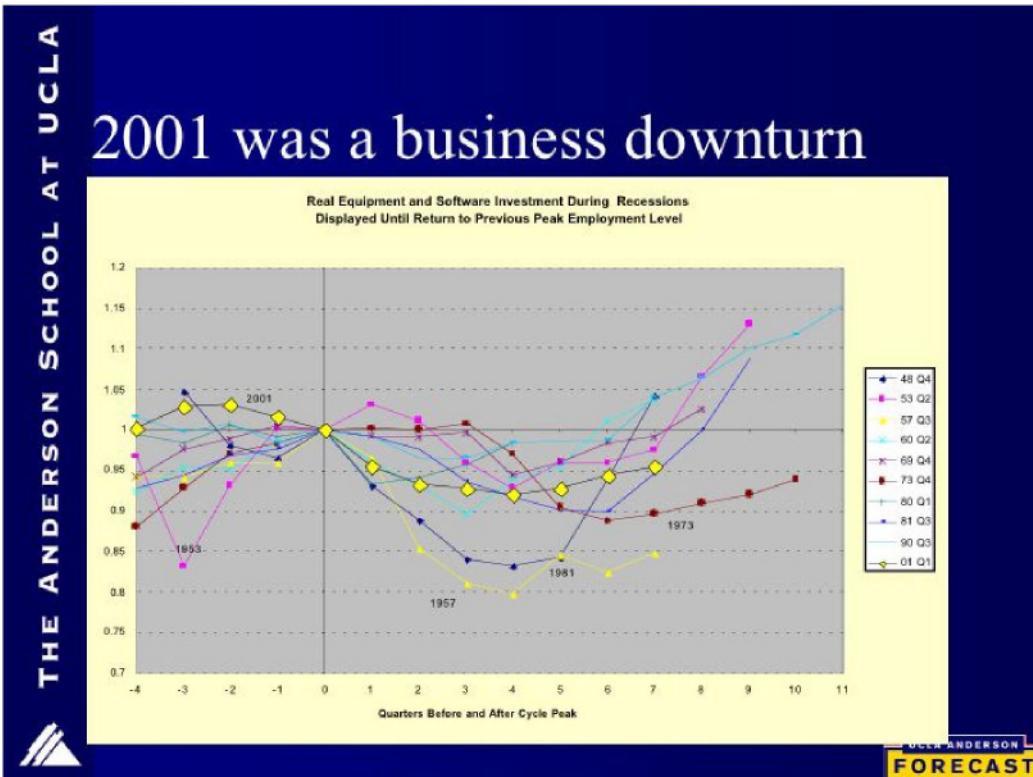
No Progress Through 2003 Q1

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## 2001 was not a consumer downturn



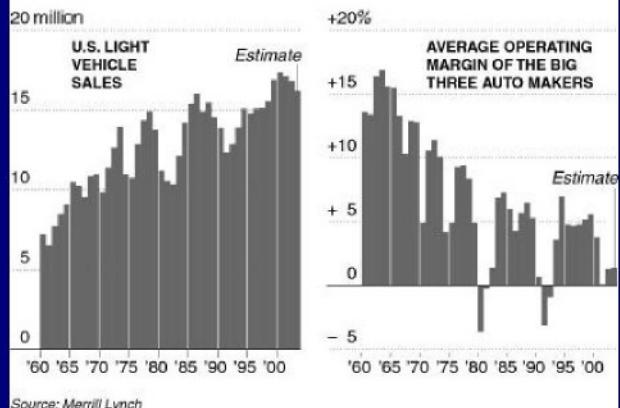
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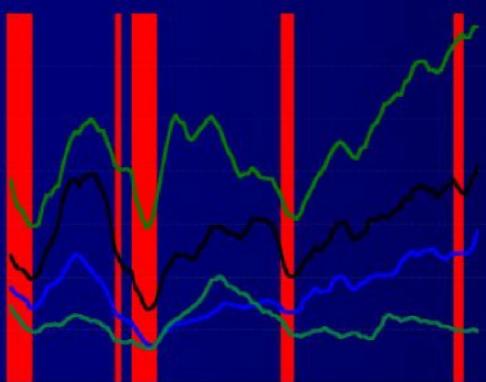
## Autos: Record Sales, No Profits

### Stalled Profits

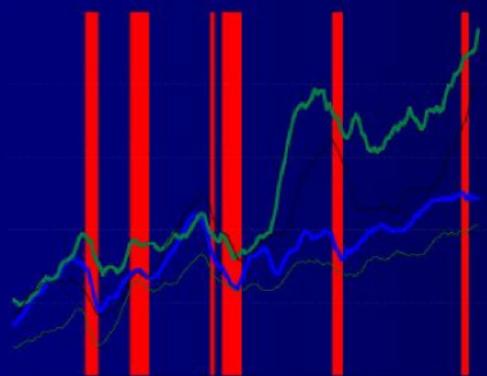
Even as sales of cars and trucks were doubling in the United States over the last four decades, the profit margins of the Big Three auto makers — General Motors, Ford and Chrysler — steadily declined.

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**FORECAST**

## Building Homes, Except in the Northeast

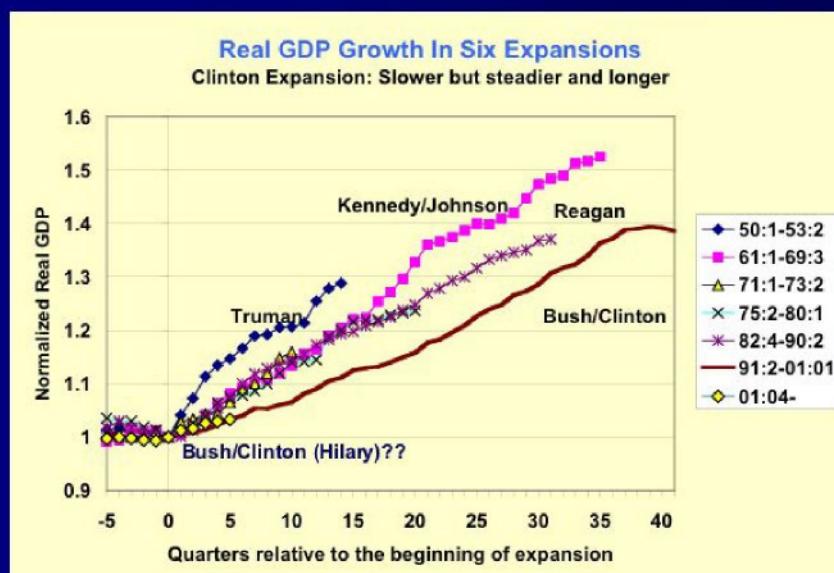
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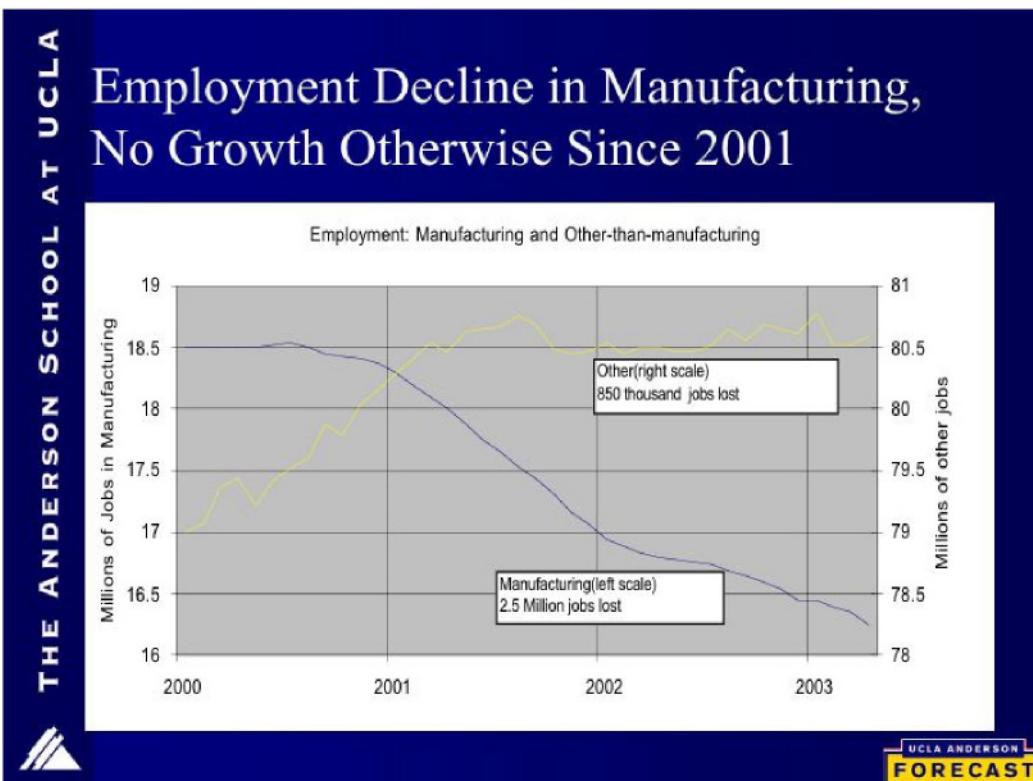
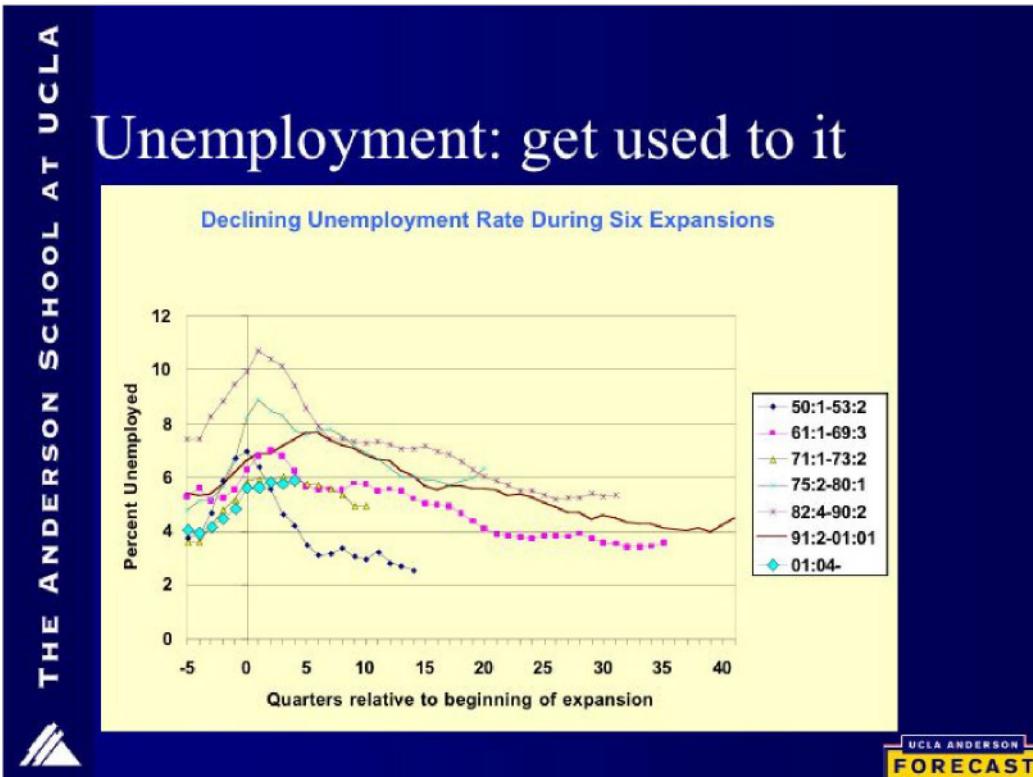
And we are putting massive phantom home assets on our balance sheets



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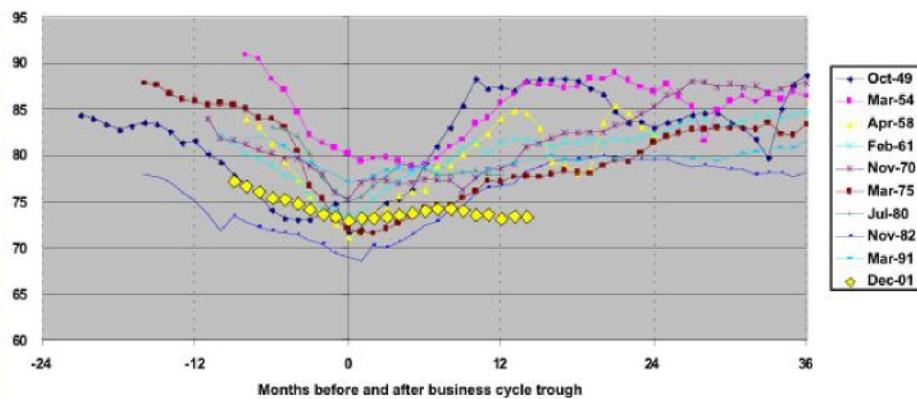
Weak GDP growth, so far.





# Don't Expect New Factories to be built in the US any time soon

Capacity Utilization in Manufacturing during Expansions

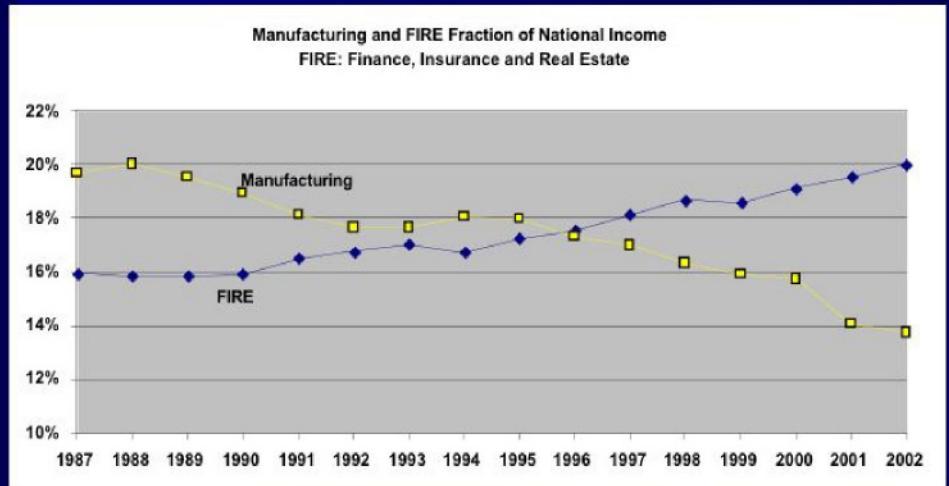
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Those lost jobs in manufacturing have been found in China

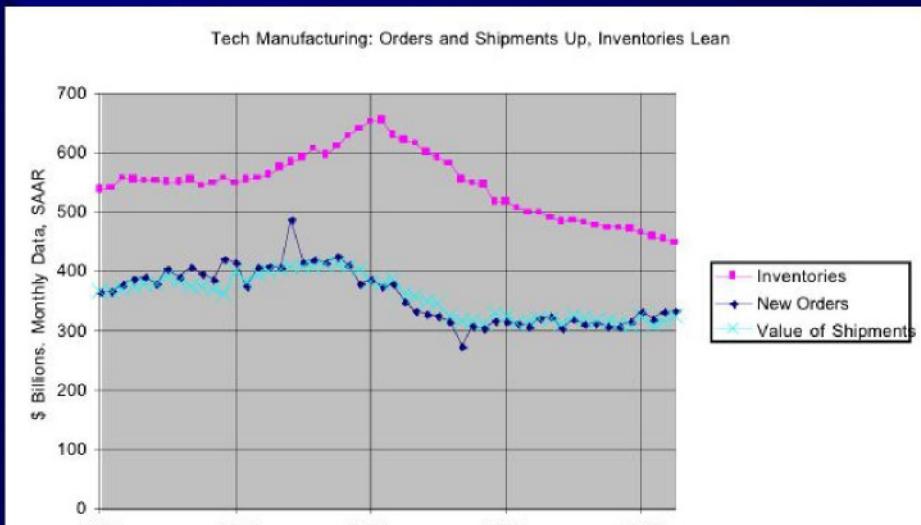
Employment in Manufacturing: Number and Fraction

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## An Ominous X

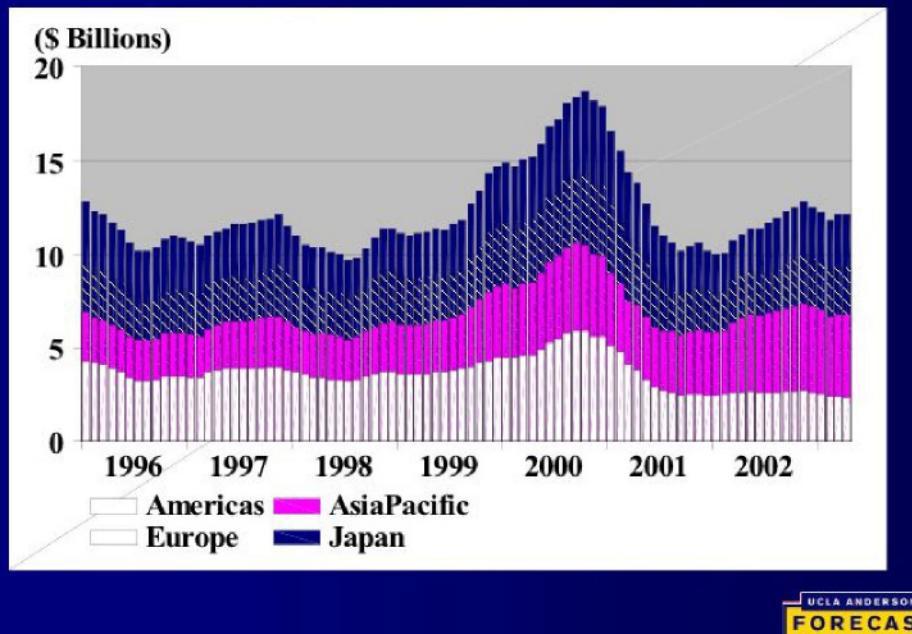
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Tech Manufacturing is bouncing along the bottom.

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## World Sales of Semiconductors

Jan. 1996 to April 2003



## It's Spending that Matters

This tax cut won't have a noticeable effect on consumer spending.

- ◆ Much of the tax relief comes later, not now.
- ◆ Much of the tax relief accrues to taxpayers with discretionary income and hefty savings.
  - The small effect on cash flow isn't going to change their spending decisions.
- ◆ The rest of us ought to be using the tax relief to draw down our debt and improve our personal balance sheets.
  - We need to lower our debt to get ready to pay the higher interest rates on our personal debt and the higher taxes to pay for the interest on the Federal debt
- ◆ Much of that consumer spending is good for China, not for us.



## 2003: Can't be that good for the Nation

- ◆ Weakness in state and local government spending is likely to be a drag on GDP growth.
- ◆ Unwise over stimulation by the Fed has created problems in the two critical consumer sectors – homes and cars
  - Inflated home prices: Phantom assets that are sure to disappear.
  - Too many new cars have already been sold.
- ◆ Businesses, now, are not a driver. They are waiting to see strong spending by consumers or government before making major commitments again.
  - Structures will bottom out early this year
  - Equipment and software spending will continue to increase with maddening moderation. These investments will increase productivity and reducing costs.
  - No need to do much hiring.



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**"ANALYSIS OF AMERICAN ECONOMIC TREND (2003-2004)"**  
**BY HUANG RENWEI**

**THREE DIFFERENT VIEWS ON AMERICAN ECONOMIC STATUS**

American government holds that American economy has entered the rising cycle in the 4<sup>th</sup> quarter of 2001. The Department of Treasury and the Department of Commerce are relatively optimistic, believing that the rise is a good and definite sign; while the Fed is cautious, believing the recovery is weak and unstable.

The Silicon Valley holds a pessimistic view, arguing that the economy hasn't ended the depression, with a poor profitability and a stagnant market performance.

New York financial world is cautiously optimistic, believing that the risk has not disappeared, but the economic fundamentals are no doubt rising.

In our opinion, American economy has begun to recover, but uncertainty still exists, especially with the problems of unemployment and "two deficits" unresolved. In addition, there is a hidden danger in the capital factor of the financial problem.

**WHY AMERICAN ECONOMY HAD BEEN DECLINING IN 2001**

1. Factor of economic cycle--the needed readjustment after a ten-year fast growth.
2. Bubbles in the New Economy and Stock Markets burst, dynamics supporting high growth went off.
3. Economic Structural factor: large-scale equipment renovation and excess R&D in 1990s led to excess productive capability and declining of private investment.
4. Federal macro control policies boosted a high interest rate, repressing investment and consumption.

Some of the above factors have disappeared, but some others are still there. Interest rate have reached the bottom line; negative growth have changed into positive growth; private investments have begun to recover and grow; stock markets have gone back to above 9000 points.

Other negative factors predicted in early 2003 did not magnify their negative impact, war against Iraq was completed soon, and uncertainties such as oil price rise did not affect long-term economic trends. The weakened U.S. dollar brought U.S. into an export growth and stock cut.

Scandals about Enron and Worldcom did not break off capital chains of financial industry on a large basis.

#### **POSITIVE FACTORS TO CURRENT U.S. ECONOMIC RECOVERY**

1. World economy has gone out of decline started from 2001, and the global economy can gain a 3 percent growth in 2003.
2. War in Iraq has settled down, bubbles in U.S. stock markets have been squeezed off, major financial shocks are unlikely. Stock market indicators show a big rally, DJ index goes up 20 percent higher than that of pre-Iraq-war, and NASDAQ saw a 30 percent growth.
3. Non-agricultural productivity maintains a high level of growth, with a rate of 4 percent both in 2002 and 2003.
4. Stimulated by low interest rate--the lowest in 40 years--and a tax cut, consumption of durables such as houses and cars continues to grow, and becomes a major factor supporting growth. House sales take 14 percent of U.S. GDP, 60 percent of GDP increment.
5. Equipment and software investments see a comeback, industrial production keeps growing for a consecutive 18 months, showing a turn-over of economic cycle curve.
6. Low inflation leaves much room to Fed monetary policy leverages. Consumption price index and production price index are about 2.5 percent in the 2<sup>nd</sup> quarter of 2003; price index of core consumption goods is less than 1 percent, lowest in 40 years.
7. In spite of a rapid growth, the fiscal deficit takes only 1 percent of GDP, much lower than 4.7 percent of 1992, and better than most western developed countries.

In this sense, a basic conclusion is U.S. economic fundamentals have entered an upward curve of recovery.

#### **INSTABILITY OF AMERICAN ECONOMIC RECOVERY**

1. Economic recession in 2001 did not last long, but it is a deep structural recession, not a traditional one characterized by recession of manufacturing industry and investment, but the first economic recession in the 21<sup>st</sup> century amid the new economy and economic globalization. The insynchronization of the new and old cycles prolongs the recession and delays coming of boom. The higher dependency of American economy on global economy set off

some effects of macro control policy of US. Major economies in the world all raise their capability of production with proliferation of new technologies, much higher than demands.

Worldwide price cut and deflation will become a long-term phenomenon. It is a problem which U.S. federal government cannot solve alone.

2. Large-scaled equipment upgrading has been completed in 1990s and a new peak of investment for equipment will not come in short term. Economic growth rate is 2.5-3 percent, and the record of 4 percent growth rate for 9 years in 1990s will all but appear. But expectations for the economic growth have been heightened to a very high level by the prosperity in 1990s, and it is hard for a 3 percent growth rate lasting for a relatively short time to satisfy psychological needs. According to the traditional economic cycles in the US, the economy is viewed as "booming" if it grows at the rate of above 2.5 percent successively for three years.
3. It is hard to reach a balance between the depreciated dollar, which is conducive to exports, and the enormous trade deficit. Dollar has actually appreciated about 40 percent against the other major currencies since the late 1990s, and the effectual weighted exchange rate of dollar is 25 percent above its actual value. Since 2002, dollar has depreciated 15-20 percent against euro and yen, regressing towards its real exchange rate. The statistics from the journal *The Economist* shows that the index for the dollar exchange rate, reckoned as 100 in 1990, reached 115.7 in 2002 and fell down to 101.6 in June 2003, near the level in 1990. However the trade deficit has expanded continuously, reaching more than \$500 billion by the June quarter of 2003. The journal *The Economist* estimates that the proportion of the current account deficit to GDP will probably be as high as 5.4 percent in 2004. Pressure on international payment brought about by the gigantic trade deficit will force the United States to take the old road of strong dollar.
4. The problem of employment will be sustained and recessive unemployment will probably worsen. The unemployment rate has been standing at 5-6 percent, and the unemployment time prolonged from 6 weeks to 20 weeks. It is very common for enterprises to axe employees due to rising productivity and the need to increase profits. Both traditional industries and high-tech industries see

employment insufficiency, resulting in a negative impact on further growth of consumption capacity.

5. Low interest rate and tax-cutting policy have led to advance release of "wealth effect." Private debts have reached a record high. Private and enterprise debts, together with the government's two deficits, make the capital chain in the U.S. vulnerable. The total amount of household debts in the U.S. has risen to 100 percent of the annual post-tax income, and outstanding consumption credit and house mortgage loans have both soared. Moreover, the new bankruptcy act will lead to more bankruptcy of households and enterprises that have debt burdens. It is obvious that gigantic debt might hinder seriously recovery of investment and consumption although it can serve as a driving force for stimulating consumption.
6. The speed and scale of inflow of international capital into the United States have obviously declined, compared with that of 1990s. FDI in the U.S. stood at only \$40 billion in 2002, while the figure was \$246 billion in 2000. The net inflow under capital account reduced 40 percent year on year in 2002. The stability of domestic and international capital chain deserves attention. If the U.S. government desires to keep its attraction to international capital, it has to shift its current policy option and adopt the policy of strong dollar and higher interest rates. As a result, wealth effect brought about by low interest rate will evolve into a larger bubble.
7. The spaces for monetary and fiscal policies are rather limited. The three months short-term interest rate has gone down to 0.95 percent, making the space for reducing the interest rate approach the limit. If the policy of reducing interest rate does not play its role, it will fall into the "liquidity trap." Although the interest rate is very low at present, the danger of deflation is still there. Tax-cutting policy and enormous fiscal deficit leave the federal government with limited room to employ fiscal leverage. The Bush administration had originally planned to cut taxes by \$800 billion within 10 years, and the figure was reduced to \$350 billion by the congress. If we take into consideration the need of anti-terrorism and the Iraqi war, sharp increase of expenditure for national defense and intelligence, and limited

financial resources for social security, it is doubtful whether the tax-cutting policy is sustainable.

8. It is hard for venture investment to obtain returns as high as that in 1990s because redundant investment and R&D in high-tech industries have not been absorbed. Furthermore, new technical breakthrough might not probably be thriving and have a large impact. Mergers and acquisitions among high-tech enterprises will go on; otherwise these enterprises could hardly shake off the burdens left over from the late 1990s.
9. The dual impact of foreign trade on the U.S. economy will be more evident. Increase of the trade deficit might drag the GDP growth rate down 1-2 percent and thus become the bottleneck for the economic recovery. If the U.S. government opts for protectionist trade policy and imposes restraint on import, the current economic situation of low inflation rate, corporate profit and consumers' welfare will be enormously affected. Therefore American policies on exchange rate and trade cannot but be swaying, with its inclination in favor of export at most times.

#### **TREND FORECAST FOR THIS AND NEXT YEARS**

1. The overall trend of the U.S. economy will be upwards during the period from the last quarter of the year 2003 to the first half of the year 2004, with the growth rate probably up to 3 percent. American economy will probably run on a normal track until the end of 2004 if there is no paroxysmal incident on the international arena and concerning American homeland security. If so, it will be favorable for Bush's reelection. American economy might go downwards without serious recession by 2005 if it grows at the rate of more than 2.5 percent successively for three years as forecasted.
2. Dollar will turn strong from its weakness for the sake of equilibrium of American balance of payments if the trade deficit is under proper control. The flowing direction of international capital will not change fundamentally and space for dollar depreciation is slim due to the fact that the fundamentals of the U.S. economy are better than that of Europe and Japan.
3. At present the bubble of American stock markets has been squeezed off basically and the bubble in the property market has not raised its head. What is noteworthy is that intemperate overdrawing of

consumption capacity has been intensified by private debts and thus efforts must be made to avoid destroying effects of another kind of "wealth effect" brought about by low interest rates.

According to this analysis, the Fed will not keep interest rates at very low level for a long time.

#### **THE IMPACT ON CHINA BROUGHT ABOUT BY THE TREND OF AMERICAN ECONOMY**

The unstable recovery of the U.S. economy might intensify instability of the economic relation between China and the U.S. and the structural problems in the bilateral trade. As a result, frictions and disputes between the two countries will be more severe.

1. The United States will probably be more inclined to take retaliatory measures on China. If unemployment rates in some industries in the U.S. stand at high levels, the Congress and some "interest groups" will ascribe it to the large quantity of imports from China and might even impose sanctions on China according to "Article 301."
2. If deflation of the United States worsens further, American government might intensify its pressure on China to appreciate the RMB value.
3. Concerned with the fact that competitive edge of China's products might be sharpened and considering the factor of its security, American government might take more stringent control of its technological imports to China. As a result, Sino-U.S. trade will be more unbalanced.

SUMMARY OBSERVATIONS ON "THE U.S. ECONOMIC OUTLOOK"  
BY BENJAMIN ZYCHER

## *Summary Observations On the U.S. Economic Outlook*

**Benjamin Zycher**

Senior Economist

RAND

**China Reform Forum/RAND Conference**

**August 28-29, 2003**

**Santa Monica, California**

## *Outline*

- Recent aggregates and trends.
- Consumer spending and business investment.
- Employment.
- Conclusions on prospective GDP growth.

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RAND

China Reform Forum/RAND  
Conference August 28-29, 2003

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## *Recent Aggregates and Trends (1)*

- Annualized GDP growth of 2.4 percent in 2<sup>nd</sup> quarter 03.
  - About 1 percent higher than median forecast.
- Domestic final purchases growth of 4.6 percent.
  - Strongest since 1<sup>st</sup> quarter 00.
- Import growth at 9.2 percent.

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## *Recent Aggregates and Trends (2)*

- **New orders for manufactured goods increased 1.7 percent in June.**
  - Manufacturers' inventories have fallen for four consecutive months.
- **Annualized rise of 5.7 percent in labor productivity in 2<sup>nd</sup> quarter, 3.8 percent year-over-year.**
  - Annualized reduction of 2.1 percent in nonfarm unit labor costs.
  - 1 percent reduction year-over-year.

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## *Consumer Spending and Business Investment (1)*

- **Consumer spending increased 3.3 percent in 2<sup>nd</sup> quarter.**
  - 3 percent annualized for first half.
- **Business investment increased 6.9 percent annualized.**
  - Real interest rate increased about 100 basis points since June (10-year inflation-indexed Treasury bonds).
  - Recent inventory reductions suggest stronger production in 2<sup>nd</sup> half.

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## *Consumer Spending and Business Investment (2)*

- **Business profitability 20 percent higher than recession trough.**
- **Business investment increasing in information processing equipment, software.**
- **Excess capacity in transportation, business structures.**

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## *Employment*

- **As of early August, weekly initial unemployment claims below 400,000.**
  - First time since February.
- **However, caution about adding workers.**
  - Nonfarm payrolls fell 44,000 in July.
  - Note: Labor markets typically lag behind economic conditions.
- **Total employment will increase, but labor force will grow at 1 percent per year.**
  - Need 125,000 jobs per month to stabilize the unemployment rate.

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## *Conclusions on Prospective GDP Growth*

- **Already apparent that 3<sup>rd</sup> quarter GDP growth will be about 4 percent.**
  - Higher real wages, higher real disposable income.
- **About 3.5 percent GDP growth through end of 04 (6 quarter average).**
- **Increased state/local tax burdens a potential problem.**

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**"THE STATUS QUO AND PROSPECT OF CHINA'S BANKING INDUSTRY"  
BY WANG YUANLONG**

Institute of International Finance, Bank of China

**CURRENT SITUATION OF CHINA'S BANKING INDUSTRY: QUANTITY AND QUALITY**

China adopted a highly centralized and planned economic system before 1978. Accordingly, a highly centralized financial system was set up. All financial services were "unified" into one service--bank credit; all bank credits were monopolized by one large bank--The People's Bank of China. Such system was generalized as a highly unified financial system. No market elements existed in such a financial system, not to say commercial banks.

State-owned specialized banks were set up or separated from the People's Bank of China after 1978, so there had been four specialized banks by 1985--The Industrial and Commercial Bank of China (ICBC), The Agricultural Bank of China (ABC), The Bank of China (BOC) and The Bank of Construction of China (BCC). In 1987, in order to break over-monopolized banking system, some share-holding commercial banks were formed such as Bank of Communications, Shenzhen's Bank of Development, and Bank of Urban Cooperative. And to meet needs of opening-up, foreign banks--Hong Kong Nanyang Commercial Bank, Citibank--started to march into Mainland China. So a commercial banking system composed of state-owned, joint-stock and foreign commercial banks came into shape. Table 1 and 2 show the evolution of China's commercial banking system.

**1. Expansion of the Scale of the Banking Industry**

The number of banks grew 100 percent, total value of asset grew 107.3 percent. See Table 1. Joint-stock commercial banks and urban commercial banks grew the most rapidly.

**Table 1**  
**China's Commercial Banking System: Expansion of Scale (1995-2002)**

Type	Numbers			Total Asset (billion dollar)		
	1995	2002	Growth (%)	1995	2002	Growth (%)
State-owned	4.0	4.0	0	8056.0	13549.6	68.2
Joint-stock	11.0	10.0	-9.1	430.8	2997.7	584.4
Urban	3.0	108.0	3500.0	30.0	1152.4	3741.0
Foreign-invested	139.0	190.0	36.7	160.4	288.1	79.6
Total	156.0	312.0	100.0	8677.2	17987.8	107.3

Sources: *China's Financial Yearbook (1996-2002)*, the People's Bank of China; *Monthly Statistics*, the People's Bank of China.

## 2. Structural Change of the Banking Industry

Its manifestation is three-fold:

Firstly, new commercial banks were set up, urban commercial banks emerged, and joint-stock commercial banks were reorganized.

Secondly, the market shares of state-owned commercial banks dropped dramatically, and those of urban and joint-stock commercial banks grew rapidly. See Table 2.

Thirdly, among state-owned commercial banks, the share of ABC grew and those of IBC, BOC, and BCC remained stable or declined slightly.

See Table 3.

**Table 2**  
**China's Banking System: Structural Change of the Banking Industry (1995-2002)**

Type	Market Share of Total Assets (%)		Market Share of Total Loans (%)		Market Share of Total Deposits (%)	
	1995	2002	1995	2002	1995	2002
State-owned	92.8	75.3	90.7	76.8	90.8	76.9
Joint-stock	5.0	16.7	6.5	16.1	8.2	16.4
Urban	0.4	6.4	0.3	5.8	0.4	6.2
Foreign	1.8	1.6	2.5	1.3	0.6	0.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Sources: *China's Financial Yearbook:1996-2002*, the People's Bank of China; *Monthly Statistics:2003-2*, the People's Bank of China.

**Table 3**  
**Internal Structural Change of China's State-Owned Commercial Banks**

Name	Assets (billion yuan, %)				Deposits (billion yuan, %)			
	1995		2002		1995		2002	
	Total	%	Total	%	Total	%	Total	%
ICBC	3107.4	38.6	4776.8	33.1	1512.7	36.3	4100.5	34.3
ABC	1230.9	15.5	2976.6	20.6	718.3	17.3	2479.6	20.8
BOC	1995.1	24.5	3593.9	24.9	1129.2	27.1	2755.3	23.1
BCC	1722.6	21.4	3083.2	21.4	803.6	19.3	2599.7	21.8
Total	8056	100.0	14430.5	100.0	4163.8	100.0	11935.1	100.0

Source: *China's Financial Yearbooks*, the People's Bank of China.

### **3. Improvement of Self-Financing Ability of the Banking Industry**

The decline of credit dependency of commercial banks on the Central Bank is the direct manifestation of improvement of the self-financing ability of commercial banks. Obviously, the higher the Central Bank's excess financing rate to commercial banks is, the higher the dependency of commercial banks on the central bank, showing a weaker self-financing ability of commercial banks. Table 4 shows rates of excess financing are on a general decline, reflecting the improvement of self-financing ability of China's commercial banks.

### **4. Diversification of Banking Services and Income Sources**

China's commercial banks maintained a simple pattern of services until the early '90s of last century: deposit, loan and settlement. The business scopes of China's commercial banks are greatly expanded. Currently, the third provision of the Law on Commercial Banks (promulgated in May 1995) provides 12 categories of services.

Because of diversification of financial products and services, the income sources of banking industry also go beyond a simple pattern of only interest revenues. In 2001, non-interest revenue of the five major banks takes an average of 20.12 percent of total business revenues among which that of BOCC is 36 percent. The proportion of middle- and small-sized commercial banks is 38 percent in average, among which that of Everbright Bank of China (EBC) is 75.7 percent. See Tables 5 and 6.

**Table 4**  
**Improvement of the Self-Financing Ability of China's Commercial Banks**  
**(1985-2001) (million yuan, %)**

Year	Reserve deposit	Excess Reserve Deposit	Deposit in the Central Bank	Loans of Central Bank of Commercial Banks	Excess Financing Rate
1985	42050	47030	89080	224860	60.4
1986	56530	55780	112310	269380	58.3
1987	67020	52750	119770	277390	56.8
1988	84140	50880	135020	338800	60.1
1989	104170	81210	185380	424600	56.4
1990	139060	141460	280520	514770	45.5
1991	180980	203150	384130	509180	24.6
1992	23354000	163120	233540	698130	66.5
1993	288460	698130	288460	989850	70.9
1994	394100	298180	692280	1031650	32.4
1995	524980	395950	920930	1117390	17.6
1996	654560	651650	1306210	1421010	8.1
1997	914330	632800	1547130	1400290	-10.5
1998*	790060	488170	1414580	1203250	-17.6
2001	---	---	1350870	843150	-60.2

\* Numbers of reserve deposit and excess reserve deposit are not available after 1998 because compulsory reserve account and payment reserve account were unified; Numbers here are statistics of the first quarter of 1998.

Source: *China's Financial Yearbook: 1986-2002*, People's Bank of China.

**Table 5**  
**Composition of Business Incomes of the Five Major Commercial Banks**  
**(2001) (%)**

Composition	ICBC	ABC	BOC	BCC	BOCC
Interest Revenue	71.00	97.13	77.60	91.67	64.00
Non-Interest Revenue	29.00	2.87	24.40	8.33	36.00

Source: *China's Financial Yearbook: 2002*, the People's Bank of China.

##### 5. Expansion of Customers of the Banking Industry

Loans to non-state-owned sectors grew continuously, and took an average of 13 percent of total loans. See Table 7. This decline after 1998 mainly resulted from a large increase of loans to infrastructure. See Figure 1.

**Table 6**  
**Composition of Business Incomes of China's Joint-stock Commercial Banks**  
**(2001) (%)**

Composition	CITIC	EBC	Huaxia	Minsheng	GBD
Interest Revenue	59.00	24.30	80.10	62.48	67.30
Non-Interest Revenue	41.00	75.70	19.90	37.52	32.70
Composition	SDB	Merchants	FIB	SPDB	Yantai
Interest Revenue	73.80	61.80	61.60	66.60	30.27
Non-interest Revenue	26.20	38.20	38.40	33.40	69.73

CITIC: Industrial Bank China International Trust and Investment Corporation

GDB: Guangdong Development Bank Co. Ltd.

SDB: Shenzhen Development Bank Co. Ltd.

FIB: Fujian Industrial Bank

SPDB: Shanghai Pudong Development Bank

Yantai: Yantai Housing and Savings Bank

Source: *China's Financial Yearbook: 2002*, the People's Bank of China

**Table 7**  
**Loans of China's Commercial Banks to non-state-owned sectors**  
**(billion yuan, %)**

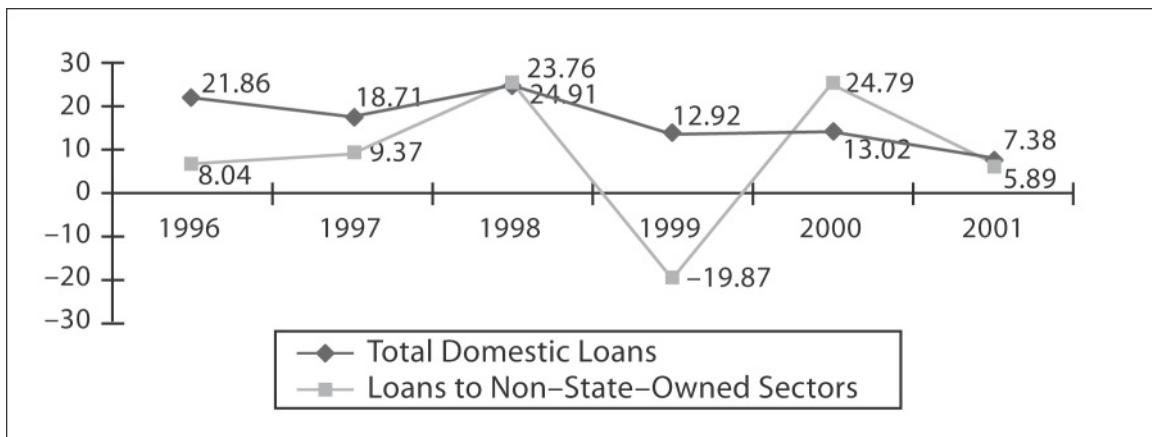
Year	Total Domestic Loans (A)	Loans to Non-State-Owned Sectors (B)	PRIVY (C)	B/A
1995	49903.5	5465.7	9.5	10.9
1996	60811.6	9859.5	14.7	16.2
1997	72186.7	10783.8	14.7	14.9
1998	89337.2	13470.0	16.4	15.0
1999	100878.7	10793.8	13.2	10.7
2000	114009.6	13470.1	15.1	11.8
2001	122421.8	14262.9	14.9	11.7

Notes: A. Total Domestic Loans = credit to the Central government + credit to other sectors + credit to non-monetary financial sectors.

B. Loans to non-state-owned sectors = short-term loan (loans to private enterprises and self-employed people, foreign-invested enterprises, township enterprises and loans to agriculture) + non-short-term loans × rate of private loans in short-term loans;

C. PRIVY = Loans to non-state-owned sectors/GDP.

Sources: *China's Financial Yearbook: 1996-2002*, the People's Bank of China.



**Figure 1--Loans to Non-State-Owned Sectors from China's Commercial Banks**

Note: Y-axis = growth rate.

Source: *China's Financial Yearbook: 1996-2002*, the People's Bank of China.

## 6. Gradual Improvement of Business Safety of Banking Industry

Positive changes took place in business safety of China's commercial banks in recent years, especially the BOC. See Table 8.

**Table 8**  
**Changes of Business Safety of China's Commercial Banks**

Bank	Owner's rights/Total Assets (%)			NPL <sup>a</sup> Reserve/Total Loans (%)		
	1995	1999	2002	1995	1999	2002
ICBC	2.98	5.12	3.73	0.76	0.68	0.85
ABC	3.31	5.90	4.57	0.62	0.90	1.24
BOC	4.77	5.61	6.11	2.08	2.09	5.20
BCC	2.32	4.86	2.80	0.01	0.97	1.03

Source: Annual reports of related banks.

<sup>a</sup> NPL = Non-performing loans.

## 7. Improvement of profitability of the banking industry

Recent years saw profitability of China's commercial banks an upward trend, in which urban and foreign banks improved dramatically. Among state-owned commercial banks, BOC's profit increased by a large margin. See Tables 9 and 10.

**Table 9**  
**Profitability of China's Commercial Banks (million yuan, %)**

Type	Profit After Tax		
	1999	2001	Growth (%)
State-owned	13150	23000	74.9
Joint-stock	7040	10500	49.2
Urban	300*	2410	703.3
Foreign	-1290	1620	225.6
Total	19200	37530	95.5

\*N/A, taking 1995 statistics as reference.

Source: *China's Financial Yearbooks:1996-2002*, the People's Bank of China.

**Table 10**  
**Changes of Profit after Tax of State-owned Commercial Banks**  
**(million yuan)**

Bank	Profit After Tax			Profit After Tax/Total Assets	
	1995	2002	Growth (%)	1995	2002
ICBC	4669	6527	39.79	0.1502	0.1366
ABC	1937	2897	49.56	0.1573	0.0973
BOC	4700	9445	100.98	0.2355	0.2628
BCC	6172	4304	-30.27	0.3582	0.1396

Sources: *China's Financial Yearbook*; Annual Reports of related banks.

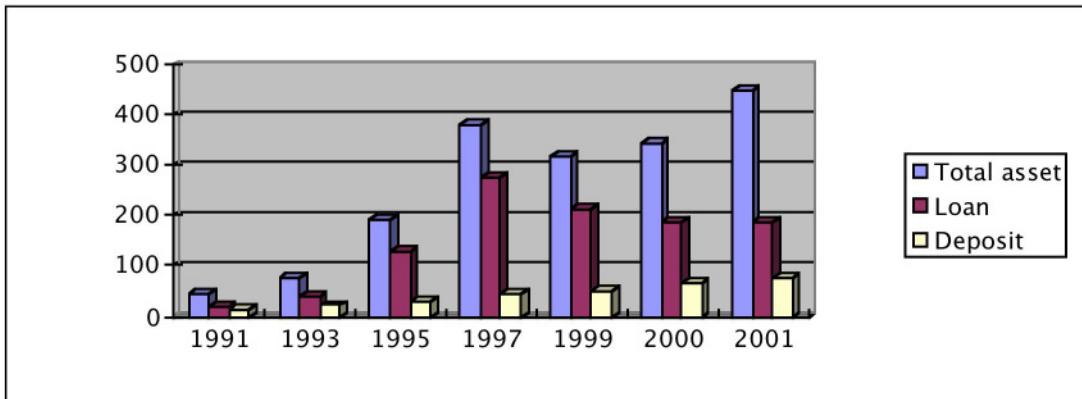
#### 8. "Quality First" Approach of Foreign Banks in China

With "quality first" as a prerequisite, foreign banks in China push forward their business in a stable manner. See Table 11 and Figure 2. They took a share of 40 percent in China's international payment and settlement market, that of Chinese Banks is 60 percent.

**Table 11**  
**Business Development of Foreign Banks (million yuan)**

Item	1991	1993	1995	1997	1999	2000	2001
Total Asset	4290	7580	19140	37920	31790	34430	45180
Loan	2050	4160	12750	27470	21470	18650	18610
Deposit	1560	2110	3140	4480	5200	6520	7750

Source: *Monthly Statistics of People's Bank of China: 2003-2*.



**Figure 2--Business Development of Foreign Banks**

Source: *Monthly Statistics: 2003-2*, the People's Bank of China.

#### 9. Interpretation of Expansion Of Quantity and Small-Scale Improvement of Quality

The expansion of quantity and small-scale improvement of quality are resulted from domestic financing structure and banking management. Its main manifestations are as follows:

Firstly, bank loan remains the major financing method. See Table 12. State-owned banks provide most loans to state-owned enterprises.

**Table 12**  
**Changes in China's Domestic Financing Structure (2000-2002)**  
**(billion yuan, %)**

Item	2002		2001		2000	
	Volume	%	Volume	%	Volume	%
Total	2423.3	100.00	1655.6	100.00	1716.3	100.00
Loans	1922.8	79.35	1255.8	75.85	1249.9	72.83
Government Bonds	371.8	15.34	259.8	15.69	247.8	14.44
Corporate Bonds	32.5	1.34	14.7	0.89	8.3	0.48
Stocks	96.2	3.97	125.3	7.57	210.3	12.25

Source: The People's Bank of China.

**Table 13**  
**Rise of Management Cost of State-Owned Commercial Banks (%)**

Bank	Business Cost/Business Expense	
	1995	2001
ICBC	3.47	19.19
ABC	14.42	38.13
BOC	7.46	25.36
BCC	19.26	37.70

Source: *China's Financial Yearbook: 1995-2002*, the People's Bank of China.

## 10. Concluding Remarks

Considering the above indicators, broad competition in China's banking industry in recent years promoted reform and development of the industry. However, this sort of competition is expansion of scale rather than improvement of quality. It proves that the "big development" of banking industry in recent 20 years is just expansion of scale, the progress of quality is not satisfactory. Financial growth weighs bigger than development. The market-style financial relations has not taken shape, fundamental changes have not taken place in banking institutions and system arrangement. There is still a long way to go for banking reform.

## CHINA'S BANKING REFORM

### 1. Motives of China's Reform of State-Owned Banks

State-owned commercial banks take a lion's share of China's banking system, so the key to China's banking reform is reforming state-owned commercial banks. Why should China's state-owned banks reform themselves? The reason is very clear, that is, without reform, China's banking industry cannot develop, or survive. However, what is the goal of reform of China's state-owned commercial banks? That is to say, what problems will the reform finally address? This vital issue remains unresolved yet.

It is generally believed in China that reform of state-owned commercial banks by shareholding and listing is to address the problem of capital reserve of state-owned commercial banks. The reason is that despite a series of policies and measures were taken in recent years to raise the rate of capital adequacy, they have not reached the level

recognized by international banks, and are not able to fetch up capital gap in short term through accumulation of after-tax profits.

Shareholding and listing of state-owned commercial banks become ever-important facing high debt rate, low self-capital, large NPLs, little financial supplemental investment, and fierce international competition.

The average rate of capital adequacy of top 10 banks (not including Chinese banks) in the world in 2002 is 11.41 percent. China's state-owned commercial banks have a large gap in this respect; thus, their ability to counter risks and expand themselves is greatly constrained. The average rate of NPLs of the top 10 banks in the world is 4.48 percent, among which those of Citibank and Bank of America are respectively 2.67 percent and 1.92 percent, but that of China's state-owned commercial banks is as high as 20 percent. More important is that, in contrast to international banks, all financial indicators of China's state-owned commercial banks are much worse (See Table 14). Especially, capital inadequacy weakens the ability of the banks to absorb losses and repay debts, thus endangering the security of the whole financial system. In this sense, to improve rate of capital adequacy is really an urgent task for state-owned commercial banks.

**Table 14**  
**Comparison of Financial Status Between China's Four Major State-Owned Commercial Banks and Large International Banks (2002) (million yuan, %)**

Ranking	Bank	First level capital	Assets	Rate of Capital Return	Rate of Capital Return	Rate of Capital Adequacy	Rate of NPLs	Staff Number	Profit per person (\$ thousand)
1	Citibank (US)	58448	1051450	38.8	2.08	10.92	2.67	282461	77.52
2	Bank of America (US)	41972	621764	24.5	1.63	12.67	1.92	142670	70.91
3	Mizhuo (JP)	40498	1178285	- 25.2	-0.97	10.56	6.46	34120	- 336.37
4	JP Morgan Chase	37713	693575	6.8	0.37	11.88	2.21	95812	26.78
5	HSBC	35074	696381	23.5	1.16	12.99	3.00	171049	47.14
6	Sumitomo Mitsui (JP)	29952	840281	-	-0.58	10.45	10.20	24464	- 198.94
7	Credit Agricole (Fr)	28876	496421	8.4	0.46	11.80	4.92	102259	22.20
8	Tokyo Mitsubishi)	25673	751480	-	-0.32	10.30	4.42	21385	- 111.85
9	UFJ (JP)	23815	616485	-	-2.14	11.04	-	24264	- 543.76
10	ICBC	23107	524235	3.2	0.14	-	-	471123	1.57
11	BOC	22085	406150	6.7	0.32	8.30	27.51	203070	6.49
23	ABC	15971	262570	-0.2	0.01-	-	-	--	--
28	BCC	14517	334061	4.4	0.19	6.88	19.35	316329	1.98

Source: *The Banker*, July 2002.

However, to address the problem of capital inadequacy or to raise rate of capital adequacy is just one of the motives, or superficial cause of the reform of state-owned commercial banks. The deep cause is to set up modern commercial banking system. Its basic requirements include the following two aspects:

Firstly, to set up clearly defined financial equity structure. It is well-known that the state-owned equity pattern is in name a solely-invested pattern, but who represents the ownership is actually unresolved, leading to an unclear equity relationship, non-personalization of capital and separation of ownership and operation, ill-defined relationship among responsibility, rights and interests, ineffective self-restrain system, and low efficiency and profit. Under this pattern, state-owned commercial banks cannot get rid of state interference. Moreover, the relationship between creditor and debtor is

unclear. Banks as creditor and enterprises as debtor are all owned by state, so there are no real credit or financial transaction relationship between them, resulting in a large amount of NPLs. The reform of state-owned commercial banks is to set up financial equity structure suitable to modern commercial banking system and to give state-owned commercial banks position of independent legal status and autonomy in management, to separate government from enterprises and get rid of all kinds of state interference. A clear equity relationship is also conducive to setting up effective internal management system and effective restraint on business institutions and its staff members.

Secondly, to set up good corporate governance system. Current corporate governance of China's state-owned commercial banks has many serious pitfalls. Based on current state-solely-invested equity pattern, the formation of boards of directors, boards of supervisors and appointment of management are decided by the government, the boards of directors become white elephants and whether the board of supervisors can play some role remains to be watched. It is difficult to exert effective control on management, not to say coordination between all aspects of corporate governance. It should be noted that even some corporate governance systems are built up on surface, there is still a problem how to make it fully play its role.

For China's state-owned commercial banks, the current management system can play its full role only through shareholding and listing, diversification of equity and enhancement of external supervision. Shareholding reform can narrow the gap of starting points for Chinese and foreign banks.

Obviously, if reform of state-owned commercial banks is just "to supplement capital reserve of state-owned commercial banks," not to set up clearly-defined financial property rights structure and good corporate governance system, the reform will fail in the half way. Undoubtedly, if so, the state-owned commercial banks will follow the steps of state-owned enterprises, that is, ineffective or weak corporate governance system is still there, efficiency and profit are as low as ever, NPLs grow as ever, and quality of assets is still on the decline. If so, listing can only temporarily raise its rate of capital adequacy, it will drop easily, this "hole" cannot be filled, and state-owned

commercial banks will be debt-ridden, and development of stock markets will be distorted.

In a word, only through well-defined financial equity structure and good corporate governance system can many positive effects come out amid reform of state-owned commercial banks, including addressing capital inadequacy fundamentally, improving management efficiency, preventing and controlling financial risks, dealing with new situation after entry into WTO, optimizing structures of listed companies in capital markets, promoting strategic adjustment of state-owned economy, etc.

## **2. Equity Control in the Reform of China's State-Owned Banks**

It is a key question in the reform of state-owned commercial banks how to arrange the position the state should hold. It is an established custom and theoretical stereotype that state's absolute control in equity structure should be ensured in shareholding reform of state-owned commercial banks. As a matter of fact, commercial banks are not sectors on which the state should maintain monopoly. Their capital management is completely a market behavior or commercial activity, so the state should not necessarily maintain its monopoly in equity structure of commercial banks. If the absolute control is over-emphasized in the reform, the commercial banks will become nothing different from state-owned solely invested banks. As to banks' expansion of their own capital, the state's absolute control must limit capital concentrating function from other capital sources, leaving expansion of banking capital still constrained by government financial capability; thus the requirement of increasing scale of banking capital management is difficult to meet. According to international practices, the minimum shareholding proportion to control votes is 50 percent, not "an absolute control." The key to the problem is whether it is possible to effectively improve management, raise the rate of capital adequacy and lower the rate of NPLs. The only effective approach to prevent and resolve financial risks is to diversify equity, which can assimilate internal and external capitals, form a good corporate governance system, enable state-owned commercial banks to be market players responsible for their own management, profit, development. Only in this way can their vigor be

encouraged and a firm ground be created for high efficiency and risk-prevention.

There are two major options of equity arrangements for reform of China's state-owned commercial banks: one is absolute control, that is, the proportion of state-owned stock rights weighs more than 50 percent in total capital stocks of commercial banks; the other is relative control, that is, the proportion of state-owned stock rights weighs less than 50 percent in total stock principals of commercial banks, because of diversification, the state-owned rights maintain a position of control. Speaking from China's situation, the shareholding reform needs not cling to the "absolute control," but a relative control is a much more ideal choice.

### **3. Risk Prevention of Reform of China's State-Owned Commercial Banks**

There are many risks in reform of state-owned commercial banks in which the most important ones are:

- a. Credit risk. State-owned commercial banks have been supported for long by credit of government, and are able to get large amount of low-cost funds to support their low-efficiency operation with this monopolistic state credit. Shareholding reform changes their state solely invested status, and deprives them of credit guarantee from the government, so a payment crisis may come out as a result of loss of confidence of depositors, and the risk of liquidity may be more visible.
- b. Risk of financial system. Because of rampant insider control in financial activities, reverse options and moral hazards are inevitable. Consequently, danger and uncertainty in financial activities are increased. With insider control, any kind of risk can be transferred to investors, but the investors can not get extra return from increased risks, so the risk allocation system in which risk has a positive relation with return is destroyed. The functions of financial system will inevitably be affected, leading to heightened risks for the financial system. This development will most probably exert large impact on the effect of banking management and constraint after shareholding reform.

c. Systematic risk of financial markets. Shareholding and listing of state-owned commercial banks mean integration of commercial banks with financial markets, which inevitably increases systematic risks of Chinese financial markets; risks of banking industry are connected with those of security industry, and once there are major fluctuations of exchange rates and interest rates, they will influence and infect each other.

We must attach great importance to risk in the process of reform. Undoubtedly, a good corporate governance system is the solid basis for prevention and control of risk. Moreover, it also depends on improvement of macro financial environment, such as perfection of laws and regulations, setting-up of deposit insurance system, and advance of market reform of interest rates.



"CHINA'S FINANCIAL SECTOR: CHALLENGES AND REPERCUSSIONS"

BY K. C. YEH

China's sustained economic growth in a deteriorating financial environment raises some interesting questions. Is the Chinese economy heading towards a financial crisis? Some, like Lardy, believe that a crisis is imminent. [Lardy, 1998.] Others, like Cheng, are not so sure. [Cheng, 1999.] Moreover, the divergent trends in economic growth and financial reform challenge the conventional economic wisdom that a sound financial system is crucial to economic growth. [McKinnon, 1973; Fry, 1987.] Does it mean that China's case is an exception to the general rule? Or, alternatively, is it possible that the general principle holds but that the damaging effects of financial repression in China have been exaggerated as some government officials maintain? To clarify these issues, this note examines the nature and origin of the major problems facing the financial sector, and explores how these problems could stifle economic growth and escalate into a financial crisis.

In the last two decades, the financial sector has grown tremendously.<sup>1</sup> As a result, substantial financial deepening of the economy has taken place.<sup>2</sup> More significantly, the financial system has been undergoing a drastic structural transformation. The mono-bank system of the pre-1978 era has been replaced by a much more broadly based system with many new financial institutions, instruments and markets. Nonetheless, all these remarkable changes notwithstanding,

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<sup>1</sup> From 1978 to 2000, gross value added in the financial sector increased 15-fold, compared to GDP growth of 7.4-fold over the same period. Employment in the financial sector increased 4.2 times, while total employment in the economy rose only 1.8-fold. SSB, 1997, p. 39; SY 02, pp. 54, 57, 122-123.

<sup>2</sup> *Financial deepening* refers to the degree of monetization of economic activities. Financial deepening is indicated by the rapid rise in the ratio of money supply (broadly defined to include currency in circulation and demand and time deposits) to nominal GDP, from 0.24 to 1.65, in the ratio of total financial loans to GDP, from 0.52 to 1.17, and in the deposits of households with financial institutions 350-fold during 1978-2001. World Bank, 1995 p. 208; SY 02, pp. 51, 320, 662; SSB, 1989, pp. 431, 433.

reform of the financial system is far from complete. To be sure, a rudimentary structure is now in place, together with laws and regulations that specify the functions of various financial institutions. The problem is that essentially the financial system has changed its organizational framework but not its functions. The newly established financial institutions have not really assumed the roles that they are supposed to play in a decentralized, market-driven economy. In many ways, the financial system still operates in more or less the same mode as it did in a centrally planned economy. Meanwhile, other sectors of the economy steadily progress toward a market economy, and their financial needs rapidly grow, but these needs have been largely unsatisfied. As it is, the system has three major shortcomings: the lack of a strong, independent central bank; a fragile commercial banking system; and major gaps in the development of capital markets, a supervisory framework, and rural finance.

#### **AN INEFFECTUAL CENTRAL BANK**

The ultimate policy goal of China's central bank, the People's Bank of China (PBC), is to maintain monetary stability. [Chen, 1994, p. 31.] Thus far, the record of the PBC's performance in this respect is not very impressive. In the two decades since the PBC became a central bank, the economy experienced several episodes of high inflation, in 1984-85, 1988-89, and 1993-95, a *prima facie* evidence of its failure to attain its primary goal. The causes of inflation in China were many, and different factors played the key roles in different episodes.<sup>3</sup> But common to all cases was an upsurge in money supply before the outbreak of inflation. [Yi, 1994, pp. 50-51; Ou, 1995, p. 65; SA 01, p. 79.] Apparently, the PBC had lost control of money supply, and the sharp increases in money supply led to inflation.<sup>4</sup>

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<sup>3</sup> For example, in the 1980s, pent-up demands for housing and consumer durables, persistent budget deficits, and policy errors were important. In the early 1990s, inflation was mainly the result of an upsurge in investment following Deng's southern tour, and rapid growth of exports after the yuan devaluation. Cheung, 1989, p. 595; Ou, 1995, pp. 62-64; Zhou, 1993, pp. 81-92; Yi, 1994, pp. 191-230; 1995, pp. 51-58.

<sup>4</sup> PBC officials candidly admitted that money supply was excessive and

The reasons for the PBC's inefficacy are not far to seek. It lacks the autonomy to formulate and implement monetary policies independently. Nor does it have the means to effectively exercise monetary management. In 1995, the People's Congress enacted the People's Bank Law. [Dai and Gui, 1997, p. 274-285.] The Law represents an important step forward in financial reform but it has some shortcomings, not the least of which is to place the PBC "under the leadership of the State Council."<sup>5</sup> Apparently, government officials do not consider the PBC's lack of independence in policy-making a serious drawback.<sup>6</sup> There are, however, reasons to believe otherwise. First, under the current system, the PBC cannot really pursue its primary objective of maintaining monetary stability, because the system requires

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that central bank controls were not effective. Dai, 1997, p. 97; Wu, 1998, p. 20. For an empirical study of the relationship between growth of money supply and price level changes, see Ren, Qiu, and Yan, 1995.

<sup>5</sup> Monetary policy is to be formulated by a policy council, which comprises the PBC governor and vice governors, presidents of the four specialized banks and the People's Insurance Company of China, and one vice minister each from the Ministry of Finance, State Planning Commission and the State Commission for Restructuring Economic Systems. The membership of the council indicates that the ministries have some say in policy formation, thus diluting the PBC's decision-making power. Subsequently, a Monetary Policy Commission was established in 1997 to design various monetary policies. However, the Commission is an advisory organization, not an independent policy-decision body like the Open Market Committee of the Federal Reserve System, Wu, 1998, p. 26. In any event, the State Council must approve key policy decisions by the PBC on money supply, interest rate, foreign exchange rate and other important items mandated by the State Council.

<sup>6</sup> Liu Hongru, former Vice Governor of the PBC, played down the significance of the PBC's lack of independence by pointing out that not all independent central banks can control inflation and that some less independent ones can. Hainan, 1992, p. 179. The implication is that central bank independence is neither a necessary nor a sufficient condition for inflation control. Dai Xianglong, Governor of PBC, argued that China was able to curb inflation in the 1990s not so much because of effective monetary control but because of effective administrative control. Dai and Gui, 1997, pp. 31-32. The strongest proponent of non-independence is perhaps Zhou Zhengqing, another Vice Governor of PBC. He argues that monetary policy should be a component of economic policy and therefore it should be subordinate to government economic decisions. Zhou, 1993, p. 34. Not all PBC officials or academics share this view. Wu, 1998, p. 21; Dong Furen 1994, pp. 969-971. Some argue that legal stipulation is unimportant, as illustrated by the Bank of England. Hainan, 1992, pp. 3-4. The argument is not applicable to China, where the PBC lacks independence both in law and in practice.

the PBC to promote economic growth first of all. Rapid economic growth has been the overriding goal of the Party leaders from Deng Xiaoping to Jiang Zemin and Zhu Rongji.<sup>7</sup> To sustain such high growth, the leaders rely heavily on investment.<sup>8</sup> When the growth momentum becomes too intense and comes into conflict with monetary stability, inflation control would have to give way to economic expansion. Furthermore, the PBC has been tasked to implement other government policies by directing its resources to preferred industries, enterprises and regions. [Zhou, 1993, pp. 34, 56-57.] Involving the PBC in resource allocation could weaken its role as the monetary authority pursuing monetary stability because it may not be able to resist the demand for funds in times of inflation.

The problem of the PBC's lack of independence has yet another dimension, interference from the Ministry of Finance and local governments. Until 1993, the Ministry of Finance regularly borrowed from the PBC to cover state budget deficits. The PBC's financing of the budget deficits had a direct effect of increasing the volume of basic money.<sup>9</sup> In 1993, the government decreed that the PBC henceforth could not lend to the Finance Ministry. The decision eliminated the Ministry's direct borrowing, but indirect financing of the state budget by the PBC persisted in the form of central bank policy loans that should have been funded through the state budget, such as investment in infrastructure in poverty-stricken areas, operating losses of state-owned enterprises (SOEs), and non-profit public facilities. Again, such practices could circumscribe the PBC's ability to regulate money supply.<sup>10</sup>

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<sup>7</sup> Dai Xianglong mentioned a target of sustained growth of 8-9 percent per annum. PBC, 1994, p. 14.

<sup>8</sup> Thus, China's investment rates have been among the highest in the world, averaging 36 percent during 1978-2001. World Bank, 2001, pp. 298-299; SY 02, p. 63.

<sup>9</sup> For example, in 1993, PBC loans to the Finance Ministry totaled 154 billion yuan, which accounted for 14.3 percent of the PBC's total assets. Chen, 1994, p. 28.

<sup>10</sup> Other ministries also interfere with PBC operations by pressuring the PBC for more loans for special projects under their ministries and for more low-interest loans. They also support the financial institutions under their jurisdiction to evade central bank supervision, such as

No less significant is the interference with the PBC branches by regional and local governments. In 1996, there were 31 provincial branches of the central bank and about 2,446 branches at the lower level. The local cadres often pressed the PBC branch managers for more loans or to assist local financial institutions to apply for licenses, and they interfered with the PBC's enforcement of financial discipline. [Wu, 1998, p. 38.] The managers of the local branches of the PBC generally cooperated with the officials, because they operated under the dual leadership of both the PBC head office and the local government, and their careers depended to a considerable extent on their relationships with the local administration.

The strong influence of provincial and local government over monetary matters has constrained the PBC's ability to operate as a central bank. Indeed, the unruly situation has led some economists to believe that abuse of political power by local governments was the root cause of inflation in China. [Cheung, 1993, pp. 83-86.] In an attempt to eliminate local cadres' interferences, the government in 1993 decided to re-centralize lending powers. The PBC branches no longer had the power to lend, to allocate loans, or to adjust the loan ceilings. In 1998, the government went one step further and reorganized the thousands of local branches into nine regional ones. However, even if the PBC is free from intervention by local governments from now on, the PBC remains a tool of central government policy. Numerous empirical studies have shown a strong inverse correlation between central bank independence and inflation. [Long and Summers, 1992, pp. 103-108; Grilli, Masciandaro and Tabelini 1991; Cukierman, 1992; Alesina, 1998.]

Apart from the lack of independence in setting monetary policy, the PBC also suffers from the lack of effective tools to implement monetary policy. In principle, the PBC has a number of policy instruments at its disposal: indirect controls of money supply through deposit reserve requirements, rediscounts, open market operations and interest rates, and direct controls through mandatory credit plans and lending to financial institutions. In practice, none is really

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letting these institutions operate outside their boundaries or lend beyond their loan quota. Chen, 1994, p. 29.

effective in regulating money supply, with the possible exception of the credit plan. Take the case of reserve requirements. The system was first introduced in 1984 and required all financial institutions to deposit with the PBC a specified proportion of their own deposits. Over the years, the PBC has adjusted the ratio a number of times, for example, from 10 percent in 1985 to 13 percent in 1988, and subsequently to 8 percent in 1998. Ostensibly, the purpose is to regulate the growth of money supply by lowering or raising the credit multiplier.<sup>11</sup> However, PBC officials readily admit that, as a tool of regulating money supply, the required reserve system is of limited usefulness for several reasons. [Zhou, 1993, p. 49.] First, the primary function of the system is not to regulate money supply but to mobilize and redistribute funds by the PBC. Raising the reserve ratio has little effect on the volume of basic money in the hands of the commercial banks, because almost immediately the PBC lends out the increase in deposits by the banks back to the banks in the form of policy loans. [Dai and Gui, 1997, p. 71; Development Research Center, 1994, p. 72; Dai, 1997a, p. 129.] Second, in a system of mandatory credit ceilings, required reserves as a regulatory tool had a restraining effect on a bank only if its credit limit exceeds the volume of loanable funds allowed by the reserve system. In times of inflation, the credit ceilings are generally lowered to levels below the bank's loanable funds, in which case, changing the reserve ratio has little meaning.<sup>12</sup>

While the required reserve system has limited effects on money supply, its use by the PBC to redistribute funds has some negative effects on economic efficiency. The PBC pays an interest on the reserves: 7.2 percent per annum on required reserved and 8.4 percent on excess reserved. The rates were considerably lower than what the commercial banks could earn if the funds were lent out, and were also lower than the marginal cost of funds to the banks. [World Bank, 1990, p. 11; Dai, 1997a, p. 129.]

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<sup>11</sup> The credit multiplier shows the scale by which an initial change in commercial bank deposits will change the total credit for the economy. It is measured by the inverse of the required reserve ratio.

<sup>12</sup> This explains why the credit multiplier during the period 1985-91 was only 2.5, even though the reserve ratio technically permitted credit to expand 7-10 times the initial deposit. Zhou, 1993, p. 54.

Another conventional tool is open market operations. In 1993, the PBC began experiments with such operations. At that time, the PBC had few debt instruments in its portfolio to sell when inflation began to flare up. The total outstanding stock of treasury bills was too small to accommodate open market operations without causing large swings in interest rates [Cheng, 1999, p. 14; Zhou, 1993, p. 37.] Furthermore, secondary markets for treasury bills are still fragmentary and underdeveloped. Not surprisingly, in 1997, open market operations were virtually suspended. [Wu, 1998, p. 25.] Although subsequently revived, the volume remained relatively insignificant.<sup>13</sup> For similar reasons, rediscount by the PBC has not become a major instrument for monetary management.<sup>14</sup>

In a market economy, interest rate adjustment by the central bank is a powerful tool to influence overall economic activity. In China, however, interest rate policy is relatively insignificant as a weapon against inflation. Virtually all interest rates are administratively set by the PBC.<sup>15</sup> Among them are the loan and deposit rates of the financial institutions that affect the investment and saving behavior of firms and households. But there are constraints to raising these rates in times of inflation. The state banks dominate the banking sector and the SOEs have become heavily dependent on bank loans to finance their operations.<sup>16</sup> Any increase in interest rate would add to their financial burden substantially, because returns to capital of the SOEs have already fallen to rather low levels.<sup>17</sup> In any case, the SOEs face

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<sup>13</sup> In 1999, the PBC injected 192 billion yuan into the financial system through open market operations. Liu, Wang and Li, 2001, p. 56. It amounted to only 12 percent of the total increase in broad money supply.

<sup>14</sup> In 1996, the volume of rediscount by the PBC was 135.8 billion yuan, less than 2 percent of the total funds in the hands of the financial institutions. Dai, 1997a, p. 148; SA 01, p. 78.

<sup>15</sup> There are some quasi-market rates, such as the inter-bank short-term lending rate, the interest rate on treasury bills on secondary markets, and the curb rates in the informal financial sector. The volumes of financial transactions at these rates are presumably small with the possible exception of the curb rate.

<sup>16</sup> In 1990, 73 percent of the working capital of the SOEs came from bank loans. PBC 1994, p. 17.

<sup>17</sup> The profit-capital rate of state-owned industrial enterprises had dropped continuously from 5.5 percent in 1978 to 1.2 percent in 1999. SSB, 2000, p. 54.

soft budget constraints, so that they are not deterred from borrowing even if capital costs are higher. And, there is no point for the PBC to raise interest rates in order to divert funds to projects with higher economic returns, for credit is rationed largely on the basis of political and social considerations.

Nor can the PBC raise the commercial banks' deposit rates too high, lest it push the banks into the red, as the spread between loan rates and deposit rates is already quite thin. The government thus faces a dilemma. The PBC should raise bank deposit rates to ensure the continued inflow of household savings.<sup>18</sup> But in so doing, it increases the costs to the banks and puts them in a financial bind; just as raising the loan rates could impose a financial burden on the SOEs. To deal with this dilemma, the government introduced indexed deposits to keep real interest rates for fixed deposits from falling, in 1988 and 1993. But they were abolished as soon as inflation subsided, apparently out of concern over costs to the banks.

The PBC's interest rate policy is not only ineffective in curbing inflation; it also has adverse effects on economic efficiency. First, the rates are set at levels below the market rates.<sup>19</sup> The relatively low rates distort relative costs and encourage the use of capital-intensive techniques in a labor-surplus economy. Moreover, the structure of interest rates is not always rationally set.<sup>20</sup> The most serious effect on efficiency stems from the PBC's preferential rates designed to subsidize certain industries and social groups. The volume of loans made at preferential rates is considerable.<sup>21</sup> The preferential

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<sup>18</sup> The World Bank has found that household savings in China were rather sensitive to real interest rate changes. World Bank, 1990, p. 52.

<sup>19</sup> This is suggested by the gap between the official rates and the curb rates, by the differences between the official rates in Shenzhen and the market rates across the border, and by the almost insatiable demand for funds at the official rates.

<sup>20</sup> For example, the PBC set the commercial bank loan rate lower than that for treasury bills for the same maturity date. The result was a tremendous demand for bank loans, since the borrowers with access to bank credit could easily profit from the rate differential. PBC, 1994, p. 160.

<sup>21</sup> In 1992, it accounted for 28 percent of the total loans by financial institutions. Zhou, 1993, p. 10. In 1997, there were over 20 such rates, and, according to a PBC official, these subsidies will remain in the near future. Dai, 1997a, pp. 141-142.

pricing of credit is likely to result in inefficient use of financial resources. Low-cost funds are often used to support projects with low rates of economic return. The discriminatory treatment of different borrowers creates an uneven field of competition. The subsidized SOEs are under less pressure to reform. [Ou, 1995, p. 74.] The rather large differences between the preferential and official rates, and between the official and curb rates, invite corruption of cadres with the power to allocate credit.

For all these reasons, the PBC uses the indirect controls sparsely and relies primarily on the credit plan and lending to the commercial banks to regulate money supply. [PBC, 1994, p. 17.] The credit plan establishes mandatory ceilings on loans by financial institutions, so that, even if their deposits with the PBC increase as a result of changes in reserve requirements, PBC lending or foreign exchange reserves, they cannot expand credit beyond the ceiling set by the credit plan.<sup>22</sup> The ceilings are adjusted from time to time to vary the degree of tightness of control. Apparently, the credit plan has been quite effective in regulating credit expansion. [Dai, 1997a, p. 48.] Nonetheless, there are loopholes in the system. Strong pressures on the PBC branches from SOEs and local government often make it difficult to keep the volume of bank loans within the limit set by the PBC head office, particularly if they request additional funds to support the priority projects. DRC, 1994, p. 70; Ou, 1995, p. 61.] The banks could also bypass the ceiling by lending outside regulated channels. [World Bank, 1990, p. 49; 1996, p. 31.] Then, credit supplied by private lenders in the informal sector could dilute to some extent the effectiveness of the credit plan.

Besides the fact that indirect controls were not working well, the PBC adopted the credit plan to allocate financial resources according to the government's industrial, regional development and income distribution policies.<sup>23</sup> The PBC's arbitrary allocation of the loan

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<sup>22</sup> For the basis in formulating the credit plan, see World Bank, 1990, pp. 37-38. For its implementation in the 1980s and early 1990s, see Ou, 1995, p. 60; Zhou, 1993, pp. 97-138.

<sup>23</sup> Specifically, the government's priorities in allocating funds are: (1) working capital for the purchase and stockpiling of key agricultural products, for the large and medium-size SOEs, particularly those in basic industries, "polar industries," and high technology industries,

quota gives rise to distortions in resource use, by restricting competition, fragmenting financial markets, and encouraging "regulatory arbitrage" and corruption. Ou, 1995, p. 76.] Moreover, the controls inevitably thwart the commercialization of the specialized banks. Because credit is rationed on the basis of the borrowing needs of local governments and enterprises and the strength of their political influence, sub-optimization at the regional levels occurs at the expense of efficiency at the national level.

In 1998, the government scrapped the credit plan. That leaves direct lending by the PBC as the only primary vehicle for direct control.<sup>24</sup> The Vice Governor of PBC believes that by flexible use of central bank lending the PBC can control money supply. [Zhou, 1993, p. 49.] The problem is that the PBC may not have such flexibility. There are strong demands from the state banks and the Finance Ministry for loans from the PBC, and these demands are hard to resist. [PBC, 1994, p. 17.] Furthermore, foreign exchange reserves have been increasing rapidly since the mid-1980s, over which the PBC has little control.<sup>25</sup> [Zhou, 1993, p. 59.] More significantly, one of the main purposes of central bank lending in China is to direct resources to support certain government programs. The funds go through the state banks, but they all have designated uses.<sup>26</sup> In addition to lending to banks, the PBC also lends directly to key enterprises as directed by the State Planning Commission. Again, the mixing of monetary policy with industrial policy by the government weakens the PBC's role as the central monetary authority.

To sum up, the institutional framework for monetary management is inherently flawed in that the PBC remains a tool of government policy. The PBC is also poorly equipped to regulate the monetary aggregates.

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and for state commercial enterprises; (2) fixed investment in key projects; (3) regional development plans for central and western China, and other policy loans. Dai, 1997a, pp. 161-162.

<sup>24</sup> In 2000, loans accounted for 57 percent of the PBC's total assets. Almanac, 2001, p. 358.

<sup>25</sup> In 1985, foreign exchange reserves totaled US\$ 2.6 billion. It rose to US\$ 320.9 billion in June, 2003. SA 01, p. 79; *The Economist*, July 5-11, 2003, p. 90.

<sup>26</sup> In 1992, for instance, these policy loans accounted for 90 percent of the loans by the PBC. Zhou, 1993, p. 58.

Its attempts to carry out monetary policies have been persistently undermined by the leadership's priority goals in sustaining rapid economic growth and in supporting its industrial and other policies, and by sub-optimization of local governments, ministries, and the specialized banks.

#### THE MALFUNCTIONING STATE BANKS

A second major weakness of China's financial system is the malfunctioning state banks that dominate the financial system.<sup>27</sup> Like all SOEs, they face many problems, the most serious of which is the huge accumulation of bad loans in their portfolios. The Chinese classify bad or non-performing loans (NPLs) into three categories: overdue loans (*yuqi daikuan*)--loans that have been in arrears for less than two years; stale or sticky loans (*daizhi daikuan*)--loans that have been in arrears for over two years; and non-recoverable loans (*daizhang daikuan*)--dead loans to be written off as losses.<sup>28</sup> There is no definitive estimate of the size of bad loans that the four state banks have accumulated. According to the Governor of PBC, Dai Xianglong, total bad loans of the state banks amounted to only 8-9 percent of their total outstanding loans at the end of 1999, far below the safety standard of 15 percent set by the PBC. [Zhao, 2001, p. 3; *Xin bao* (Hong Kong Economic Journal), Feb. 10, 1995, p. 3.] Most observers believe that the official estimates understate the magnitude of the problem for two reasons. First, some of the bad loans do not appear on the books as delinquent loans, because the banks simply roll them over. [Yuan, 2000, p. 12; *Jingji ribao* (Economic Daily), Feb. 20, 1995, p. 7.] Second, the official data are based on a rather lenient definition of bad loans, and a more stringent risk classification system would certainly show a much higher bad loan ratio.<sup>29</sup> The estimate of non-performing loans at 35

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<sup>27</sup> There are four state-owned specialized banks: the Industrial and Commercial Bank of China, the Bank of China, the Construction Bank of China, and the Agricultural Bank of China. In 2000, total assets of these four banks accounted for 64 percent of the assets of all financial institutions in China. Almanac, 2001, pp. 362-363, 424-436, 474-489.

<sup>28</sup> Cheng, 1999, p. 9; World Bank, 1990, p. 65. For a slightly different definition, see Mo, 1999, p. 97.

<sup>29</sup> Any loan on which no service has been made for less than 2 years is not considered delinquent by the Chinese standard. By comparison, the

percent in 2000 by the China Finance Association appears more realistic and is consistent with other unofficial estimates of the bad loan ratio, which range from 20-40 percent. [Almanac, 2001, p. 10; Zhao, 2001, pp. 3-4.]

More significantly, the volume and bad loan ratio have apparently been rising in the last two decades. Prior to 1984, there were virtually no bad loans, as funds for the SOEs' working capital and fixed investment came directly from the state budget. In the late 1980s, bad loans rose to 200 billion yuan. Since then, they increased further to 1,060 billion yuan in 1995 and 1,700 billion yuan in 2002. [Zhao, 2001, p. 8; "The World in 2003," *The Economist*, 2002, p. 114.] Bad loans as a percentage of total loans of the state banks increased from 15 percent in the late 1980s to 25 percent in 2001. [Zhao, 2001, p. 8; *Xin bao*, May 21, 2002, p. 6.] The enormous size of NPLs and its rising trend raise some interesting questions. How did the state banks get into such a mess in the first place? What has the government done about it? How effective are these measures?

The root cause of the problem lies in the poor performance and perverse behavior of the SOEs, by far the most important borrowers from the state banks. About 81.4 percent of the state banks' loans were loans to the SOEs. Not surprisingly, about 75 percent of the bad loans were loans to SOEs and collective enterprises [Zhao, 2001, pp. 5, 7.] The SOEs have been borrowing heavily from the banks and their burden of debt servicing increased sharply.<sup>30</sup> Meanwhile, their profitability has been on the decline.<sup>31</sup> Many have become loss-makers and their losses

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U.S. standard classifies a non-performing loan as one that is overdue by 90 days and a reservable loan, by 180 days. Presumably using an international standard, *The Economist*, Feb. 8, 2003, p. S-7, estimated the bad loan ratio at 40 percent in 2001, much larger than the official estimate of 28 percent.

<sup>30</sup> In 2000, the debt to asset ratio of the industrial SOEs was 70 percent, compared to only 19 percent in 1980. SY 02, pp. 433-434; Zheng, 1998, p. 73. In 1997, the SOEs had to pay 627 billion yuan for interest, which amounted to 17 percent of their gross value of output. Zhao, 2001, p. 25; SSB, 2000, p. 20.

<sup>31</sup> Profit per unit of gross output of the industrial SOEs dropped from 15.3 percent in 1979 to 2.8 percent in 1999. Over the same period, profit per unit of capital fell from 16.1 to 1.2 percent. SSB, 2000, p. 20, 53-54.

have been rising fast in the last two decades.<sup>32</sup> Some SOEs lose money because of the heavy burden of funding many social services, including the financial support of large numbers of surplus workers. Some incur losses because the state set prices below costs, as in the case of energy production and transportation. Some face sharp and protracted decline in the demand for their products, such as many producers of military goods. Some are involved in government-directed projects that fail. Some lose money simply because of mismanagement. Some are caught in inter-firm or "triangular" debts. Still others deliberately default their loans.<sup>33</sup>

Whatever the cause of the SOEs' difficulties, the bad loans would not have reached such enormous proportions without the government's virtually unlimited financial support. The SOEs have easy access to bank funds and they face no threat of bankruptcy. The key rationale of the soft budget policy is that bankrupting the ailing SOEs would create unemployment on a large scale, which in turn would lead to social unrest.<sup>34</sup> In short, the government set a higher priority on social stability than financial health, and paid the price of accumulating bad loans as trade-offs for postponing the reform of the SOEs.

The problem of government intervention actually goes deeper than the soft budget constraints. Intervention with bank lending comes from both the central and local governments. In addition to loans to provide fixed and working capital to the SOEs, central government-directed loans also finances: investment in key industrial projects, building of infrastructure facilities, projects in social development, sectoral or regional assistance, grain procurement, and mandatory imports. In the 1990s, policy loans accounted for over one-third of the loans by state banks.<sup>35</sup> Policy lending is not necessarily bad.<sup>36</sup> However, in China's

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<sup>32</sup> The number of loss-making industrial SOEs as a percentage of all industrial SOEs rose from 19.2 percent in 1980 to 35.1 percent in 2000. The corresponding amount of losses increased from 3.4 to 61.6 billion yuan. Zheng, 1998, p. 33; SA 01, p. 125.

<sup>33</sup> *Renmin ribao* (People's Daily), Dec. 10, 1994, p. 5.

<sup>34</sup> As Liu Hongru, former Vice Governor of PBC, explains, bankrupting the loss-makers makes economic sense but is politically infeasible. Hainan, 1992, p. 119.

<sup>35</sup> Policy loans as a percentage of total bank loans averaged 36.4 percent during 1990-96. Cheng, 1999, p. 7. *The Economist*, Sept. 13,

case, more often than not, these loans turn sour. For example, of the key projects developed by the state during 1986-90, only one-third could earn enough to repay their loans on schedule, one-third had large losses and their loans were overdue and the prospects of their repayment in doubt, and loans to one-third of the projects had no chance of being repaid. [Dai and Gui, 1997, p. 42.] The main reason why policy loans easily become bad loans is that the lending decisions are based not on the credit worthiness of borrowers or the commercial viability of projects, but rather, on social and political consideration, and the leaders' perceptions of what industries to develop. There are, of course, other factors, such as poor management of the loans and borrowers' diverting funds to other uses. [Zhao, 2001, p. 26.]

Intervention by the local government created similar problems. The decentralization of fiscal power to local governments in the 1980s provided a strong incentive for them to expand their revenue bases by building factories and shops. In the process, the banks were instrumental in the drive to develop the local economy. For various reasons, the banks have to cooperate, even though they know some of the loans would not be repaid. [Wu, 1995, pp. 96-97.] A large number of the local government-directed projects failed mainly because they were developed without due considerations of their comparative advantage and minimum economies of scale. Local protectionism by the government helped to set up many small factories in many localities, producing cigarettes, wine and liquor, textiles and petroleum products. These factories duplicated each other, and eventually, many had to close down.

The state banks themselves must share some responsibilities for their difficulties. Some loans made by the state banks are commercial loans, presumably based on assessment of risk, liquidity and profitability. Apparently, many of these loans have turned sour too, partly because of the bank managers' lack of skills and experience in risk and portfolio management, inadequate accounting standards, and

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1997, p. 26, reported that policy loans accounted for more than 10 percent of GDP.

<sup>36</sup> For arguments for and against policy lending, see World Bank, 1994, pp. 43-46.

underdeveloped information systems.<sup>37</sup> At the same time, the supervisory framework is weak. This lax environment has provided ample opportunities for the banks and their borrowers to engage in risky and irregular activities.<sup>38</sup> Some of them speculate in the stock market and real estate and fail. Others corrupt the system with bribery, and loan contracts are often flouted with impunity. [Cheng, 1999, pp. 15, 20.] The banks themselves prefer to keep the bad loans on the books rather than letting the borrowers go bankrupt, because the bankruptcy laws do not protect the banks, and the banks usually end up the biggest losers. [Xin bao, Sept. 6, 1995, p. 12; Zhao, 2001, p. 86.]

To sum up, bad loans originate from three main sources: the ailing SOE, the misguided policy loans, and mismanagement of the banks themselves. According to a survey by the PBC of the four state banks in 2001, the relative importance of the three main sources of bad loans is as follows: 35 percent originate from policy lending and related causes, 43 percent from poor performance of the SOEs, and 22 percent from mismanagement of the banks. [Xin bao, May 17, 2002, p. 11; Zhao, 2001, pp. 19-20.] The finding is significant, not so much because it pinpoints the blame, but because it suggests where to focus the remedial measures. Common to all three sources are some institutional flaws of the system. Hence, reducing the flow of new bad loans would require formidable reforms in the government, particularly the Finance Ministry, the SOEs, and, of course, the banks themselves. These reforms are necessary so that the banks will not fall into the same trap in the future. But, reducing the flow of new bad loans is only part, albeit a crucial part, of the problem. At this stage, the banks have to get rid of the accumulated stock of bad loans before they can operate effectively as commercial banks. This leads to the question: What has the government done to resolve these two related but distinct problems?

To be sure, the authorities have not overlooked these problems. In 1997, Chen Yuan called for a reduction of the bad loan ratio by 2-3

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<sup>37</sup> For the management and financial challenges facing the state banks in the 1990s, see World Bank, 1994, pp. 59-79.

<sup>38</sup> Stiglitz suggests that banks may be motivated to undertake large risks in the hope that the returns would cover both the new and bad loans. Stiglitz, 1994, p. 184.

percentage points each year. [WSJ, July 14, 1997, p. A 15.] In the following year, Zhu Rongji told the banks to clear up the NPLs and start lending purely on commercial basis within three years. [The Economist, June 13, 1998, p. 38.] To attain these goals, the government had adopted several measures. First, three policy banks were established in 1994 to extend policy loans so that the four state-owned specialized banks could concentrate on commercial lending.<sup>39</sup> Separating policy lending from commercial lending makes sense, because mixing the two could create many problems.<sup>40</sup> However, the policy banks have not taken over all the accumulated policy loans. [World Bank, 1996, pp. 25, 33; Wang, 2001, p. 68.] Nor has the new measure freed the state banks from the perils of new policy lending. While the local governments are now banned from interfering with the banks' lending operation, the central government is not. The Commercial Bank Law leaves the door ajar for policy lending. The Law stipulates that all banks are to operate as independent entities and genuine commercial banks after a transition period. In the mean time, all banks should conduct their lending "according to the needs of the economy and social developments, and under the direction of the state's industrial policy" (Article 34). Insofar as the government continues with policy loans, the state banks cannot avoid being involved and chances of their incurring new bad loans are far from remote.<sup>41</sup>

One major consequence of the bad loans is that the banks are losing capital fast. NPLs do not generate income while carrying them incurs costs. Meanwhile, provisions for loan loss are far from adequate

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<sup>39</sup> The three policy banks are: the State Development Bank, the China Import-Export Bank, and the Agricultural Development Bank.

<sup>40</sup> The mixing makes it impossible to assess the performance of the state banks and difficult to transform the state banks into genuine commercial banks. Losses from policy loans dilute profits from commercial loans and sometimes conceal losses from commercial loans. Funds for government-directed projects are often diverted to other uses.

<sup>41</sup> The state commercial banks are also indirectly involved with the policy banks. They have been called upon to provide capital to the policy banks, and to guarantee the loans of the policy banks. In the former case, the state commercial banks, in effect, indirectly finance policy loans through the policy banks. In the latter case, as guarantors, the commercial banks are expected to bear the cost if the loans of the policy bank become delinquent.

to write off the dead loans.<sup>42</sup> By the late 1990s, their capital adequacy ratios fell to dangerous low levels.<sup>43</sup> Relying on internal sources to re-capitalize is out of the question. The banks have not been able to generate adequate earnings for various reasons. Like other SOEs, they have to provide many social benefits to an oversized work force. Overhead costs are high because of the excessively decentralized branch system. The government's low interest rate policy simply transfers the banks' monopoly profits to the borrowers. Nor is raising capital on the stock market a feasible alternative, unless and until the banks clean up their balance sheets.<sup>44</sup> Not surprisingly, in 1998, the government had to inject 270 billion yuan from the state budget to replenish the banks' capital. The process involved the Ministry of Finance, the PBC, and the state banks. [Mo, 1999, pp. 93-94.] The Ministry of Finance sold 270 billion yuan of bonds to the state banks. At the same time, the PBC reduced the reserve ratio from 13 to 8 percent, releasing 377 billion yuan of liquidity to the state banks, with which the banks bought the government bonds. The Ministry of Finance then injected the proceeds into the state banks' capital accounts. It is interesting to note that the re-capitalization was made possible by the PBC's reduction of the reserve ratio. One limitation of the approach is that it could hardly be used again and again, particularly when inflation looms. The injection of 270 billion yuan

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<sup>42</sup> Official estimates put the dead loans at 2.7 percent of outstanding loans in 1999. Zhao, 2001, p. 3. The World Bank in 1990 noted that "annual provisioning permitted by the Ministry of Finance is currently at 0.01-0.02 percent of the loan portfolio, much lower than the level called for by the system arrears and bad loans and by normal banking practice elsewhere." World Bank, 1990, p. 69. Subsequently, the state allowed the banks to set aside provisions of 1 percent of outstanding loans, but most state banks actually had provisions less than 1 percent. Mo, 1999, p. 98; Almanac, 2001, pp. 424-425.

<sup>43</sup> The international standard is 8 percent. The ratios for the state banks before August 1998 were probably below 8 percent. Some observers believe that they were negative, i.e., the banks were technically insolvent.

<sup>44</sup> In 2002, the government planned to list the four state banks on the stock market. *The Wall Street Journal*, Nov. 15, 2002, p. A 6.

certainly helped to strengthen the banks' capital, but it represented only a fraction of the total bad loans.<sup>45</sup>

Another device to get rid of the existing bad loans is the establishment of four asset management companies (AMCs) in 1999 to dispose of the bad loans of the state banks.<sup>46</sup> The purpose is to clean up the balance sheets of the state banks so that they can start anew. The cleaning up is timely because, under World Trade Organization rules, foreign banks will have unrestricted access to China by 2007, and the state banks must prepare themselves for the competition. However, the task is formidable because the court and legal enforcement systems are weak, the volume of bad loans to be disposed rather large, and markets for the foreclosed assets underdeveloped. The AMCs can auction off the assets, convert the debt into stocks, or package the bad loans to sell to foreign investors. Each AMC has been given 10 billion yuan to start up operations. Deals made by the AMCs are financed by interest-free loans from the PBC and by bonds sold by the AMCs to the banks. [WSJ, Nov. 15, 2002, p. A 6.] By mid-2002, the AMCs have taken over 1.4 trillion yuan of bad loans from the four state banks, a major chunk of which has been turned into stocks of several hundred SOEs. [Xin bao, May 21, 2002, p. 6; *The World in 2003*, p. 114.] In 2003, the AMCs sold some bad loans to several consortia led by Morgan Stanley, Goldman Sachs and the Deutsche Bank. [WSJ, April 9, 2003, p. B 5C.] However, recovery from the sales has been relatively little.<sup>47</sup> The low recovery rate could weaken the PBC, which provided the funds to purchase the bad loans.

At best, the AMCs take care of the existing bad loans. For this reason, the government has adopted additional measures to deal with the flow of new ones. One such measure is the introduction of a new

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<sup>45</sup> According to the PBC, at the end of 1997, bad loans totaled 1,500 billion yuan. Mo, 1999, p. 90. The new capital amounted to less than 20 percent of total bad loans. According to one estimate, to write off the entire stock of NPLs would cost 27 percent of GDP in 1998. Fan, 1999, p. 15. Other estimates vary from 12 to 40 percent of GDP. WSJ, Sept. 2, 1999, p. A 14; *The Los Angeles Times*, July 10, 2002, p. C 1.

<sup>46</sup> The AMCs are Cinda, Huarong, Orient, and the Great Wall.

<sup>47</sup> The Morgan Stanley Consortium paid only 8 cents on the dollar for its purchase of US\$ 1.3 billion of NPLs from Huarong. WSJ, August 12, 2003, p. A 10.

classification of loan risks. The new system follows the international standard of distinguishing four categories of risky loans: special attention, substandard, doubtful, and loss. Bad loans include the last three categories. [Zhao, 2001, p. 2.] The new system has two advantages over the old one. Being more specific, it facilitates the PBC's monitoring of the quality of the banks' assets and also provides guidelines for the banks to make bad loan provisions. As noted earlier, bad loan provisions have been far from adequate. The government has not yet announced new requirements of bad loan provisions to go with the new classification system. Nonetheless, the new system is a useful first step toward adequate loan provisioning.

Another major development is a marked change in the past policy of not bankrupting the banks and SOEs. Closing the Hainan Development Bank is a case in point. Recently the government announced plans to close 2,000 SOEs that have accumulated 240 billion yuan of bad debts. Closing these SOEs probably would not do much good in re-capitalizing the banks, because the banks are low on the priority list of creditors to be repaid in the event of bankruptcy. Still, closing the loss-making SOEs will certainly help to slow the growth of new bad loans. It should also signal other government-owned financial institutions that the government could force write-offs to clean up their financial problems.<sup>48</sup>

All these measures notwithstanding, the bad loan overhang remains large, and there is no sign that new ones have stopped forming. Will the situation degenerate into a financial crisis? Analysts' assessments differ. Some believe that a crisis is inevitable and may even be imminent.<sup>49</sup> The bad loans are soft assets, but the household deposits are hard liabilities. At present, China does not have a deposit insurance system. At some point, a liquidity crisis could be triggered

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<sup>48</sup> For example, the government has allowed the collapse of the Guangdong International Trust and Investment Corporation in 1998 and the Fujian International Trust and Investment Corporation in 2002.

<sup>49</sup> According to the World Bank, China's banking system is a time bomb. *WSJ*, Sept. 2, 1999, p. A 14. *The Economist*, Dec. 11, 1999, p. 65, predicted that "beyond three years or so, only fundamental reform can avert a systemic banking crisis." By contrast, both Andy Rothman of CLSA Emerging Markets and the Moody Investor's Service did not believe that "the banking system would collapse over the next few years." *WSJ*, Nov. 15, 2002, p. A 6.

by some incident. Thus far, there has been no loss of public confidence in the banks, despite the fact that they are technically insolvent. This is mainly because the government implicitly guarantees household deposits in state banks. As long as the deposits are backed by the state, the liabilities of the state banks are protected. If widespread bank runs should occur, the PBC, as lender of the last resort, could readily defuse the crisis by providing whatever liquidity needed to restore public confidence.<sup>50</sup> A sharp increase in money supply may result, but the PBC can use various means to reduce the inflationary pressure. For this reason, PBC officials dismiss the risk of a financial crisis. [Dai and Gui, 1997, p. 46.]

The debt overhang on the banks' asset side is a different matter. Cheng has argued that bad loans essentially are debts incurred by the state to itself. Apart from moral hazard, the bad debts should be of no concern, insofar as the debts are domestically held and the income distribution effects of public debt service are negligible. [Cheng, 1999, p. 18.] True, but the adverse effects of bad loans on economic efficiency go far beyond moral hazard. First, the bad loans represent a one-way flow of household savings into a bottomless pit. A good loan replenishes itself, forming a circular flow so that, over time, the banks' financial resources remain more or less intact. In China's case, the one-way flow dissipates financial resources and reduces the capacity of the banks to make new loans. Until the growth of bad loans slows or stops, the loss of resources would continue to drain the banks' loanable funds and eventually would constrain the supply of capital for economic growth.

Second, the very process of turning large volumes of current savings into bad loans represents a misallocation of resources on a gigantic scale. On the one hand, the loans generate no economic returns from the ailing SOEs or bad projects. On the other, there is a rather high alternative cost, because depleting the banks' loanable resources

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<sup>50</sup> Bank runs have occurred in China before. In June 1988, residents in some cities such as Wuhan and Chengdu withdrew large volumes of deposits to buy goods in anticipation of price rises following price reform. But the crisis abated when the PBC immediately supplied liquidity to the banks. Xia, 1996, p. 42.

further limits the supply of credit to the productive enterprises in the non-state sector. Already, the state sector absorbed about 70 percent of lending but contributed less than 50 percent of GDP. [Restall, 1999, p. A 14.] A shortage of credit for the dynamic non-state sector could have a significant impact on overall economic growth.

Third, the large volume and continued growth of bad loans complicates and delays economic reforms. Commercializing the state banks would be extremely difficult with the banks losing capital continually. The bad loans may also have a disincentive effect on enterprise reform. The badly managed SOEs could get away with overdue loans, whereas the efficient ones have to pay interest and principal. In effect, the well-managed SOEs subsidize the bad ones. The disincentive effect on the well-managed SOEs could lead to wastes in resource use. At the same time, the sick SOEs take for granted the financial support from the banks so that they too have little incentive to become more productive. They might resist reforms in order to protect their vested interests.

Interestingly, the troubles of the state banks have an indirect but positive effect on privatization of the financial sector. Privatization took place, not in the form of changing the ownership of the state banks, but in the growth of non-state financial institutions in the financial sector.<sup>51</sup> The state banks' lending has always been biased against non-state enterprises.<sup>52</sup> The growth of bad loans further limits state bank lending to the non-state sector. The result is an acute shortage of credit for the non-state enterprises, particularly the small and medium-size ones.<sup>53</sup> The non-state enterprises are forced to turn to non-state financial institutions for credit, including the non-state banks and institutions in the informal sector. The non-state banks are profit-oriented and have better credit control. Their

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<sup>51</sup> The non-state banks include some large joint stock banks, one private bank, a number of urban cooperative banks, and foreign banks.

<sup>52</sup> For example, of the total short-term loans extended by all financial institutions, loans to REs, PEs and individual businesses, and foreign-funded enterprises accounted for only 15 percent. SA 01, p. 78.

<sup>53</sup> The problem has prompted entrepreneurs and economists to call for the development of more private banks. *South China Morning Post*, May 15, 2002, p. 4; Lin and Li, 2001.

performance is better than those of the state banks.<sup>54</sup> The growth of these banks introduces some competition to the state banks, absorbs some surplus workers from the state banks, fills a gap in the financing of non-state enterprises, and leads the way toward a more efficiently managed banking system. Thus far, the growth of the non-state sector is still limited, but there can be little doubt that it contributes considerably to raising the economic efficiency in the financial sector.

#### PROBLEMS IN RURAL FINANCE

A third major weakness in the financial system is its underdeveloped rural finance. The current financial system in the rural areas has a dual structure: a formal sector that comprises the two state banks (the Agricultural Bank of China and the Agricultural Development Bank of China) and rural credit cooperatives (RCCs), and an informal one consisting of private lenders. The major problem with the formal sector is that rural reforms have created new demands for financial services, and the state banks and the RCCs have failed to serve these needs adequately and efficiently.

Throughout the post-reform period, the government has allocated relatively few financial resources to the rural sector. In 2000, loans of the two state banks and the RCCs accounted for only 26 percent of total loans of China's financial system,<sup>55</sup> even though the rural sector produced about 43 percent of China's GDP and rural population constituted 64 percent of China's total population.<sup>56</sup> The

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<sup>54</sup> For example, the Min Sheng Bank, the first private bank in China, uses outside accounting firms to help assess credit risks and outside law firms to prepare loan agreements. Its loan quality ranked the first among all banks in 1996. Cheng, 1999, p. 9. Bad loans in the non-state banks as a whole amounted to only 2.4 percent of their assets, compared to 20 percent in the state banks. Zhao, 2001, p. 108; World Bank, 1996, p. 26.

<sup>55</sup> Almanac, 2001, pp. 374, 423-424, 482.

<sup>56</sup> We define rural output to include agricultural output, value added by rural enterprises, and output of the other rural economic sectors. For agricultural output and GDP (1,462.8 and 8,944.2 billion yuan, respectively), see SY 02, p. 51. Output of the rural enterprises (2,268.7 billion yuan) is derived from that in 1998 (2,218.6 billion yuan from SY 99, p. 412) and the assumption that it grew in proportion to employment in 1998 and 2000 (125.37 and 128.2 million from SY 02, p. 121). Output of the other sectors (95.9 billion yuan) is derived from

disproportionately small share of loans was mainly due to restricted supply of bank credit rather than to the lack of demand, as suggested by the vast amounts of private borrowing outside the formal system, noted below.

More importantly, the financial resources from the formal sector have not been used in areas where they are most needed. The bulk of the resources have been used to finance procurement of farm products by state-owned commercial enterprises, to support agricultural production, to assist the poor areas, and to subsidize the ailing REs.<sup>57</sup> Meanwhile, the demand for credit by rural enterprises (REs), private enterprises (PEs), and rural households have been neglected.<sup>58</sup> Loans to the REs have been rather small, only 20 percent of the total loans, while the REs contributed 59 percent of total rural output.<sup>59</sup> The private enterprises fared even worse.<sup>60</sup> The shortage of bank credit created great difficulties for these enterprises, because there are no alternative sources of finance in the formal sector. Organized capital markets do not exist in the rural areas. The shortages could have

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employment in this sector (42.58 million from SA 01, p.41 and SY 02, p.121) and the assumption that per worker output is the same as the average per capita income of rural households (2,253.42 yuan from SY 02, p. 343). Total rural output is thus 3,827.4 billion yuan. For total and rural population, see SY01, pp. 91, 303.

<sup>57</sup> For an example of the local banks supporting unprofitable REs, see Byrd and Lin, 1990, p.158.

<sup>58</sup> To some extent, the REs and the PEs overlap. However, the SSB provides separate employment statistics for the REs and PEs. During 1978-2000 employment in REs grew at an average annual rate of 7.1 percent, much faster than the growth of total rural employment of 2.2 percent. Employment in the private sector in 1978 was virtually nil. The SSB reported a rapid growth of employment in this sector at 9.8 percent per year during 1990-2000, again much faster than the 0.5 percent growth of total rural employment over the same period. SY 01, p.111.

<sup>59</sup> Short-term loans to REs totaled 606.1 billion yuan in 2000. SY 01, p. 638. Loans to finance fixed investments by rural collective enterprises and individual businesses amounted to 48.2 billion yuan. SY 01, pp. 160-161. Total loans by the ABC ADBC, and RCCs were 3,278.4 billion yuan. Almanac, 2001, pp. 423-424, 482.

<sup>60</sup> In 2000, short-terms loans to PEs amounted to less than 1 percent of total short-term loans by all financial institutions. SY 01, p. 638. Loans to finance fixed investments by rural individual businesses accounted for only 0.2 percent of total loans by rural financial institutions. Agricultural Bank of China, 1991, p. 69.

serious adverse effects on overall economic growth because the REs and PEs are the most vibrant sectors in the economy.

Moreover, rural household income has risen sharply since 1978, and so has the demand for personal credit to finance housing construction, purchases of durable consumer goods, and special expenditures on wedding and funerals. Thus far, the ABC and RCCs provide little consumer credit to the peasants.<sup>61</sup>

The Agricultural Bank has over 50,000 branches scattering all over the countryside. The fragmented distribution of its funds among such a large number of branches limits the lending capacity of the local branches, so that they can only make relatively small loans. The demand for funds varies among localities. Those in need of funds larger than the local banks can provide cannot access resources of those with surpluses, for two reasons. The first is widespread localism. Local government often blocks the outflow of funds from their communities. The second is that the system is poorly equipped with facilities for interregional money transfers.<sup>62</sup> What happened was that regional integration of the real economy outpaced that of the financial system. Hence, migrant workers find it hard to remit their savings back to their home villages, and REs run into difficulties making payments to suppliers outside their counties. In sum, the formal institutions' localized operations are rather inefficient in the use of funds and hinder the diffusion of growth across regions.

The growing unsatisfied demand for financial services in the rural areas has led to the revival and proliferation of private lending.<sup>63</sup>

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<sup>61</sup> For example, in 1989, total consumer loans by these institutions amounted to only 8 percent of the peasants' expenditures on housing construction. Agricultural Bank of China, 1991, p. 87; SY 90, p. 220.

<sup>62</sup> Prior to 1987, borrowing and lending between gross-root banks were not allowed. Since then, branches of ABC could deal with one another. *China Daily*, January 13, 1987, p. 4. The RCCs, however, cannot handle interregional payments except through the ABC.

<sup>63</sup> Private lending has long existed in China's rural areas. See J.L. Buck, *Land Utilization in China*, Paragon Book Reprint Corporation, New York, 1964, pp. 461-466; Hsiao-tung Fei and Chih-I Chang, *Earthbound China*, University of Chicago Press, Chicago, 1945, pp. 237-249. There are, however, major differences between private lending in traditional China and the current case. Not only are the volume and variety of lending organizations in the current period much larger, the loans are

The private lenders include households and individuals with savings, credit associations (*hui*), pawnshops, indigenous private banks (*gianchuang*), and cooperative funds.<sup>64</sup> They are generally local institutions, small in size, and independent of the formal system. Some of these institutions are illegal (e.g., private banks). Others operate with the tacit consent of the authorities (e.g., pawnshops, cooperative funds). They charge much higher interest rates than the formal institutions. Their customers are mainly households and small businesses with cash flow problems, particularly private enterprises that have virtually no access to commercial loans from the banks.

According to one survey, almost two-thirds of the loans of rural households in 1990 were from the informal sector, and private lending as a source of rural finance had become increasingly important since 1985.<sup>65</sup> The growth of private lending has its origin in the failure of the formal sector to provide adequate financial services. But the informal sector itself has some distinct advantages over the state banks and RCCs. Their customers do not have to go through cumbersome procedures imposed by the state banks. Their deposit and loan rates are flexible, and they change with market conditions. The private lenders generally have better information on their borrowers than the banks.

Undoubtedly, private lending has alleviated credit shortages in the rural areas and thereby helped to sustain economic growth. And, by lending to the fast growing REs and PEs, the private lenders channeled the peasants' savings into uses that were more productive than the policy loans of the formal institutions. Moreover, the proliferation of private lenders introduced competition in the rural financial markets and weakened to some degree the monopolistic position of the state banks. For example, the RCCs in Wenzhou had to offer higher and flexible deposit rates in order to compete.

There are, however, serious problems created by the resurgence of private lending. First, the informal institutions operate outside the

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mainly used to finance non-agricultural projects. Deng and Xu, 1994, pp. 109-132; Kuo and Liu, 2002, pp. 40-46.

<sup>64</sup> In addition, merchants provide financing to their customers. Rural enterprises raise capital by collecting funds from their workers.

<sup>65</sup> Deng and Xu, 1994, p. 109.

formal system. The PBC has little control over the activities of these institutions. This loophole thus weakens its influence over total money supply.

Second, the lenders generally charge a nominal interest rate much higher than the official rate, ranging from 20-40 percent a year.<sup>66</sup> In some areas, it is even higher. The curb rates are higher because of larger risk premiums, higher opportunity costs of capital, higher inflation rates, higher transaction costs, and the monopolistic positions of the credit suppliers. The Supreme Court has ruled that the curb rate cannot legally exceed four times the bank rate for the same type of loans.<sup>67</sup> The high rates could bring elements of instability into the system. Higher interest costs force the borrower to invest in high return projects, which generally are also high risk ones. They also increase the financial burden to the borrower and hence heighten the risk of their not being able to service the debt. The high rates also create opportunities for corruption. The spread between curb and official rates represent a subsidy to whoever has access to bank credit. Those who obtain bank credit could make an easy profit simply by re-lending on the curb market and bank officials determine who should get the benefit.<sup>68</sup> Furthermore, the interest spread makes the ground uneven for competition between those with and those without access to bank credit.

Third, the informal system is inherently weak for various reasons. The legality of private lending remains unclear. At times the government takes a liberal attitude, and at others, such practices are banned.<sup>69</sup> The private lenders have limited capital, no access to PBC loans, and generally lend on a personal basis without collateral. Their capability to withstand a crisis is thus quite limited. More significantly, these institutions operate with no effective supervision or regulation by the state and have become hot beds for financial

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<sup>66</sup> *The Economist*, July 3, 1993, p. 30; Zhan, 1996, p. 51.

<sup>67</sup> Dong Biao, 1994, p. 2.

<sup>68</sup> Actually, cases of such private lending of public funds are quite common. Zhang, 1996, p. 51.

<sup>69</sup> For example, in 1984, the local government in Wenzhou approved the establishment of four private banks. In less than three years, the State Council closed them down.

disputes and a potential source of financial chaos. The financial disputes are difficult to resolve partly because the legality of private lending is unsettled and partly because the legal system itself is underdeveloped. If a major financial disaster in the informal sector should occur, it could quickly spread to the formal system by undermining the public confidence in all financial institutions.<sup>70</sup>

#### **CONCLUDING REMARKS**

In the last two decades, the Party leaders have tried hard to maintain a balance between the three basic policy goals: economic growth; political social, and economic stability; and systemic reforms-- apparently in that order of priority. Thus far, they have achieved a delicate balance, but only at the expense of weakening the financial system. The government used the financial system as an instrument to sustain high economic growth, to avert social unrest, and to fund institutional changes. In the process, the financial system has developed some major weaknesses that could gravely affect economic efficiency and bring on a financial crisis.

The first major problem is an ineffectual central bank. The PBC is weak because it is not an independent monetary authority with a single goal of maintaining economic stability, and because there are serious limitations to the effectiveness of its policy instruments in the current financial environment. Interest rate changes have little meaning if the environment is not liberalized. Open market operations are hardly feasible without a well-developed secondary market for treasury bills. The effect of changing required reserve ratios on money supply could be neutralized by changes in central bank lending at the behest of the government. The crucial point is that the PBC cannot be the monetary authority for macro-economic management and implementer of government development and social policies at the same time. As long as the dual function remains, the potential for high inflation is there.

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<sup>70</sup> For example, in 1986, a credit association in Leling County, Zhejiang, failed. Peasants immediately withdrew large amounts of their deposits from the RCCs, forcing one-fourth of the RCCs in the county to close. Deng and Xu, 1994, pp. 121-122.

An independent and well-equipped central bank is a necessary but not sufficient condition for effective monetary management. A viable banking sector responsive to the PBC's signals and policies need to be in place. At this juncture, the state banks are hardly viable because of the large debt overhang. Although the debt overhang and some trigger event could cause a confidence crisis, in our judgment, a collapse of the state banks is a remote possibility, because of the implicit guarantee of bank liquidity by the government. However, the economy could suffer a serious efficiency loss as the banks' bad loans drain economic resources, and as the growth of the dynamic non-state sector slows because of shortage of capital.

One possible source of financial chaos is the unregulated and under-supervised informal sector, particularly in the rural areas. The proliferation of private lending has provided much needed financial services to small, private enterprises, but it has also sowed seeds of potential trouble because of the high curb rates and lack of regulation and supervision. All these problems point to the urgent needs for fiscal reforms to relieve the PBC and state banks of their non-commercial functions; enterprise reform and social security reform to stop the drain of resources; and privatizing the financial sector by allowing more non-state financial institutions to compete with and complement the state banks.

#### **ABBREVIATIONS**

JJYJ	<i>Jingji yanjiu</i> (Economic Research)
PBC	People's Bank of China
PE	Private enterprise
RCC	Rural credit cooperative
RE	Rural enterprise
SA	Statistical Abstract
SOE	State-owned enterprise
SSB	State Statistical Bureau
SY	<i>Statistical Yearbook</i>
WSJ	<i>Wall Street Journal</i>

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**"ANALYSIS OF CHINA'S NEW PATH OF INDUSTRIALIZATION  
FROM A GLOBAL PERSPECTIVE"  
BY HUANG FANZHANG**

The report delivered on the opening day of the 16<sup>th</sup> congress of the Communist Party of China stresses that it remains as an arduous historical mission to realize industrialization in the process of the modernization drive. It points out that China should take a new road of industrialization, clarifying the direction and the basic route for China's economic development.

There are two key points here: First, it stresses that it remains as a historical mission to realize industrialization. The word "remains" in this argument has a significant connotation, meaning that our historical mission of realizing industrialization has not been fulfilled although the world has stepped into the information era. We must not relax our endeavor, still less slip it from our mind or skip the stage. Second, it stresses to take a new road of industrialization, meaning that it is a road different from the traditional road of industrialization. In my view, there are two aspects to the so-called "traditional" road of industrialization. First, from the perspective of the domestic history of industrialization, it refers to the industrialization carried out under the conditions of the past planned economy; second, from the perspective of the world history of industrialization, it refers to the road of industrialization successfully traipsed by developed countries. The historical mission of realizing industrialization and the decision to take a new road of industrialization are determined by current domestic and foreign economic conditions. This paper tries to analyze from a global perspective the historical mission China has to fulfill and the historical opportunities China should take hold of.

**THE HISTORICAL MISSION OF INDUSTRIALIZATION**

The industrialization process in the world, which was started by the Industrial Revolution in the 18<sup>th</sup> century, produced a band of industrialized countries within two to three hundreds of years. By the

end of the 20<sup>th</sup> century, 64 out of the more than 200 countries in the world had basically achieved industrialization.<sup>1</sup> These countries had long stepped into the post-industrial society before entering the stage of informationization. Since the 1960s, an industrialization process has been started worldwide, which is centered on developing countries and regions. Those countries and regions concerned were colonies or semi-colonies over a long time in the past. Only after they achieved political independence in the 1960s after World War II did they start to push their industrialization independently. To discriminate it from the first round of industrialization of the world that lasted for over 200 years and which was centered on developed countries, I call this developing countries-centered industrialization the second round of industrialization of the world, or belated industrialization of the world. China's industrialization should belong to the second round of industrialization of the world.

There are two points to the economic connotations of the historical mission of realizing industrialization. One is to transform a country from an agriculture-dominated-economy society into an industry-dominated-economy society, that is, to increase enormously the proportion of the secondary (mainly industrial sector) and tertiary (mainly service sector) industries to its GDP while lowering by a large margin the proportion of its primary industry (mainly agricultural sector) to the GDP. The other point is to improve employment structure by enormously lowering the proportion of labor in the primary sector. China could achieve this goal by transferring a large number of redundant rural laborers to industrial and service sectors and granting them status of urban dwellers in the process of industrialization and urbanization. The world history shows that it takes an agricultural country several decades or even a hundred years to achieve the historical mission of realizing industrialization.

China has made great headway in its endeavor to realize industrialization over the past half century, but it is still in the transitional period from the dual economy to the modern economy. Table

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<sup>1</sup> Song Jian, "Manufacturing Industry and Modernization," *Economic Daily* on Sep. 26, 2002.

1 indicates that over the past 40 years the proportion of the primary sector's value added to the total value added of the commodity production has dropped from 36.16 percent in 1961 to 15.23 percent by 2001, while that of the secondary sector has risen from 31.88 percent to 51.15 percent. Meanwhile the proportion of the laborers in the primary sector to the employment structure has declined from 77.17 percent in 1961 to 50 percent by 2001, while the same figure for the secondary sector gone up from 11.16 percent to 22.3 percent. These figures unarguably signify the progress of industrialization.

According to studies by the United Nations Industrial Development Organization and World Bank, a country is at the stage of semi-industrialization when the proportion of its secondary industry to the GDP is between 40 percent and 60 percent. According to this standard, China currently should belong to the category of semi-industrialization. We are faced with a flinty reality caused by the dual economy, that is, farmers, who account for 50 percent of the social labor force, only produce 15.23 percent of the commodities of the country and support more than 63.9 percent of China's population. It is the crux of China's rural problems.

To solve these problems, China should try to find a way out from a non-rural perspective, that is, from the perspective of industrialization or urbanization that is related to industrialization. China should resort to the development of manufacturing, service and other non-agricultural industries to transfer a large number of redundant laborers from the rural areas (of course, it is indispensable to strengthen agricultural technological upgrading).

**Table 1**  
**Changing Structure of China's Economy, 1961-2001**

Item Year	Structure of the added value (%)			Structure of Employment (%)		
	Primary industry	Secondary industry	Tertiary industry	Primary industry	Secondary industry	Tertiary industry
1961	36.16	31.88	31.96	77.17	11.16	11.67
1971	34.06	42.15	23.79	79.72	11.20	9.08
1981	31.79	46.39	21.82	68.75	18.19	13.06
1991	24.46	42.11	33.43	59.70	21.40	18.90
2001	15.23	51.15	33.62	50.00	22.30	27.70

Source: *Chinese Statistic Yearbook*, 2002, Table 3-1 and Table 5-2.

The Center of China Studies under the Chinese Academy of Sciences estimates that China had about 142 million redundant laborers in 2000, accounting for 42.45 percent of the total number of rural laborers. According to another analysis, if China maintains an annual average growth rate of 7-7.5 percent in the following two decades, the proportion of labor in the primary industry in the social employment structure will drop from the current 50 percent to 30-32 percent. That is to say, 140 to 150 million redundant laborers will flow out of the rural areas. They will be absorbed by the manufacturing, service, and other non-agricultural industries.<sup>2</sup> Meanwhile, if the national economy grows at an average annual rate of 7.0-7.5 percent, the proportion of the manufacturing value added to the total value added of the commodity production is expected to grow by an annual 0.70-0.75 percent. Then, the proportion of the secondary industry to the GDP will be raised from the current 51 percent to around 64 percent by 2010, which is the internationally recognized standard for an industrial nation. This is an important historical mission China faces if it is to realize industrialization.

Another historical mission is to improve the structure of industry. The technological development capacity should be enhanced and on that basis, the equipment manufacturing industry should be developed vigorously. The equipment manufacturing industry is the material carrier of the industrial technological innovation. It is the driving force of the manufacturing or for that matter, the whole industry. China's manufacturing industry has had basic production capacity. It is better developed than that in other developing countries. However, its technological basis is weak, making it lag behind the requirement of the manufacturing industry. Another research report maintains that, "China's equipment manufacturing industry is in the fourth place of the world in terms of value added, only less than that of the United States, Japan, and Germany. However, when we examine the 'Made in China' equipment, we find most of the equipment is with 'domestic body and foreign mind,' China's overall technological level of equipment

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<sup>2</sup> See Lin Yifu, "The Agricultural Issue and China's Future Rural Development," *Macro-economic Forum*, No. 12, 2002.

manufacturing lags 20-30 years behind that of the technologically-advanced countries.<sup>3</sup> The fact is thought-provoking. According to a book on this issue published recently, "Among all the problems facing China's equipment manufacturing industry, the essential one is weak technological development ability and poor quality of manufacturing and processing."<sup>4</sup> What has caused those problems? In my view, one reason is that although China is active in introducing advanced technology and equipment, it has failed to put adequate resources into absorbing, understanding and further improving those technologies and equipment, which weakens its ability to develop technology and equipment independently. The other reason is that although foreign enterprises can transfer the general technologies to China, they strictly limit the transfer of their core technologies. Even those foreign firms that have had investment or even R&D centers in China would not give up the patents of their technologies. According to the head of the China National Bureau of Intellectual Property Rights, in 1998 the number of various types of industrial enterprises in China was more than 7.97 million. Only 3 percent (or 2,474) of them applied for 2,480 innovation patents. In contrast, the U.S. enterprises in China alone applied for 5,433 patents while the Japanese enterprises applied for 7,588 patents.<sup>5</sup> It becomes obvious that China lagged far behind the developed countries in terms of technological development and that foreign enterprises have strict control of their technologies. This further makes it necessary and urgent to establish and strengthen China's independent technological R&D capacity.

Whether China is to build itself from a dual economy into a modern one, or to improve its industrial structure, it must go through the stage of industrialization and accomplish that historical task. As historical materialists we should respect the laws of historical development and bear in mind the fact that the stage of industrialization is insurmountable. We must not be anxious to surmount

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<sup>3</sup> See "Development of Equipment Industry Has Stepped into a Key Period," *Economic Daily*, Dec. 19, 2002.

<sup>4</sup> See Hu Chunli, *Restructuring Production Organizations: New Thoughts on Developing China's Equipment Industry*, China Planning Press, p. 9.

<sup>5</sup> *Economic Daily*, Dec. 19, 2002.

the stage of industrialization only because the developed countries have entered the "post-industrial society" and the information era. However, we must bear in mind every now and then the historical missions we should fulfill at the stage of industrialization, in particular the task of transferring about a hundred million redundant farmers from rural areas. Meanwhile we are opposed to mechanistic materialism. China should neither go through the long period of hundreds of years as the developed countries had done in achieving their traditional industrialization, nor should it wait for the end of industrialization before starting to initiate its informationization. On the contrary, China should make use of informationization to push forward its industrialization. The road China is to take should be a new one that respects laws of history and at the same time abides by the concrete domestic situation. It is a new road of industrialization pointed out in the report delivered on the opening day of the Chinese Communist Party's 16<sup>th</sup> National Congress. In that way, China can accomplish the task of industrialization within a shorter time and with a better quality.

#### **A NEW ROAD OF INDUSTRIALIZATION**

What are the connotations to China's new road of industrialization? From the perspective of the world economic history, China's new road of industrialization, compared with the road of the traditional industrialization the developed countries went through, has epochal features endowed by the new historical conditions.

First, China's new industrialization belongs to the second round of industrialization of the world, which is centered on developing countries and regions. The industrialization carried out by China and other developing countries is belated industrialization of the world, compared with the traditional one the developed countries went through. These countries and regions concerned were reduced one after another to colonies or semi-colonies of the then major industrialized countries during the historical period of the traditional industrialization. We can say that almost all of the present major developed countries had their own colonies or semi-colonies and resorted to colonial pillage and exploitation when they pushed forward their industrialization. This is

one of the historical features of the traditional industrialization. However, developing countries are independent countries built on the basis of collapsed world colonial regime. When these countries carried out independently their industrialization, they did not and could not repeat the beaten tracks of the colonizing empires. The aim of their industrialization is to build the past colonial or semi-colonial economies into modern ones, and therefore their road of industrialization is a far cry from that of the traditional industrialization taken by the major developed countries. China's socialism economic system ensures that it can depend completely on its own strength to realize industrialization. The aim of China's new industrialization is to turn the existing dual economy into a modern one and build China into a well-off society in an all-round way on the basis of the efforts of the past decades. This is a creed for peaceful construction China has made clear to the world.

Second, China's new industrialization is carried out in the information era. As the world has entered the information era, some of the major developed countries have stepped into the "post-industrial society" with the high and new technology represented by the information industry being its dominant industry. On the one hand, we must be clearly aware that China's stage of industrialization lags by a historical stage behind the stage of informationization traipsed by some developed countries in terms of the level of economic and scientific development. On the other hand, we should realize that the information era provides China with a great historical opportunity. The key lies in whether we are clearly aware of it, particularly whether we are good at seizing this opportunity. The report delivered on the opening day of the Chinese Communist Party's 16<sup>th</sup> National Congress definitely points out that "We should take a new road of industrialization that adheres to the line of using informationization to push industrialization, which is in turn used to promote informationization. The new road will feature advantages of high technological contents, more economic benefits, low resource consumption, less environmental pollution, and high-quality human resources." This is the basic strategy China will take in pushing industrialization in the information era, and it provides us with a reliable guarantee to firmly take hold of this historical opportunity.

The most prominent feature that makes China's new road of industrialization different from that of the traditional industrialization is the great historical opportunity brought about for China by the information era. It is well known that major developed countries used to turn to mechanization, electrification, automatization and other scientific and technological means to push and realize their industrialization. During the process of their industrialization, which lasted for about two hundred years, these developed countries had no idea about informationization. China's industrialization lags two hundred years behind that of the developed countries, but we can use informationization to push forward the development of industrialization, which is in turn used to promote informationization. Using informationization to push the development of industrialization does not in any sense mean to use informationization to "replace" industrialization. A main manifestation of the role of informationization as driving force for industrialization is using the high-tech, which is represented by information technology, and other applicable technologies to reform traditional industries. Traditional industries are by no means the so-called "sunset industries." High technology, which is represented by informationization, is quite competent in penetrating and upgrading traditional industries such as the manufacturing industry. The information technology can be applied to product design, R & D, production, management and marketing and can greatly improve product quality, efficiency and profits of production, thereby accelerating the development of the traditional industries, on the basis of incorporating high-tech and traditional technologies. Using informationization to push the development of industrialization is China's most important latecomer advantage.

Third, another latecomer advantage China can fully make use of is to combine the vigorous introduction of surplus capital and advanced technologies from the developed countries and regions with one of its inherent comparative advantages, namely, rich human resources. China should fully bring out this advantage to accelerate its economic development.

China has a large store of labor resources. Moreover, it is blessed with low labor costs, even lower than those in some Southeast

Asian countries. What China lacks is capital and technologies. These situations determine that combining vigorous introduction of foreign investment with its rich human resources is an important path for China to bring out not only its latecomer advantage but also its comparative advantages. Since it adopted the reform and opening-up policy, altogether China has actually used foreign capital of more than US\$400 billions. The foreign-funded enterprises in China have recruited more than 23 million employees. There are over 70 million professionals in the foreign trade sector.<sup>6</sup> Eighty percent of foreign capital that China has absorbed centers on the Zhujiang Delta, Yangtze Delta and the Beijing-Tianjin-Tanggu regions. China's manufacturing industry is mainly located in these areas and a large number of rural laborers from inland also flow mainly to these areas. The latest study shows that China's labor-intensive manufacturing industry will continue to be a focus of foreign investment. Moreover, the labor-intensive sections of some high-tech industries (such as electric and communications equipment) are most attractive to foreign investors.<sup>7</sup> We should not underestimate the importance of such modes of trade as processing raw materials on clients' demands, assembling parts for clients, and processing according to clients' samples and compensation trade, which are the starting point for the boom of China's coastal areas. Even now, the processing trade accounts for 55 percent of China's total exports. Although the income of the processing trade is low, it can boost employment. Recently some foreigners expressed fear that "the more successful China becomes, the faster the growth of payment costs will be, which is a result of intensified scramble for laborers." They fear that as a result, "China may lose its glory as a manufacturing base."<sup>8</sup> In reality, these fears are groundless, because China has vast inland and diverse cross-regional economic levels. It means that the country has a vast potential space for the extension of the development of the manufacturing industry. When the salary level of China's middle and

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<sup>6</sup> Shi Guangsheng, "The Fast Development and its Implications of China's Foreign Trade." *Economic Daily*, Oct. 18, 2002.

<sup>7</sup> State Council Development Research Center, "Analysis of Trend of Foreign Direct Investment," *Economic Daily*, Aug. 19, 2002.

<sup>8</sup> Philip Dai, "China May Lose Its Charm as a Manufacturing Base," *Asia Wall Street Journal*. Dec. 30, 2002.

western areas rises to the level in the coastal areas, the country will have already entered the well-off society.

One of the important aims of introduction of foreign investment is to introduce advanced and high-tech technologies. In regard to the manufacturing or high-tech industries, it's difficult to introduce the most advanced technologies from other countries into China. But it's possible to introduce and acquire applied advanced technologies. It's no use to take a pessimistic attitude or insist on starting from scratch. Instead, China should make full use of the existing technological results. The key is for China not to feel satisfied with copying advanced technologies, but to make efforts to digest and absorb the technologies and make innovations to transform them into its own technologies. Recently, the World Bank Chairman James D. Wolfensohn published an article in Japan's *Yomiuri* on January 16, 2003, stressing that the East Asian economic mode should be transformed from imitation to innovation. He pointed out that countries centering on the manufacturing industry, such as China, must follow that strategy to further expand their market. Only by undergoing the transformation from introducing technologies to innovating self-owned technologies can the latecomer advantage be brought out.

Fourth, China should draw the lesson from the developed countries during their industrialization period when their natural environment and resources were severely damaged. China should never reapeater-walk the old road of "plundering" natural resources and "first polluting, then improving the environment." While developing its economy, China should seriously and properly develop resources and efficiently use them. The environment must be protected and improved for the sake of China's following generations. A new and sustainable way of development, which features low resource consumption and less environmental pollution, should be tried.

The features of China's new industrialization are quite different from that of the traditional industrialization from the perspective of the history of the world industrialization. From the perspective of the history of China's industrialization, it also differs from the traditional industrialization China had been pushing forward during the period from the establishment of People's Republic of China to its

adoption of reform and opening-up policy. Mr. Lu Zheng and his colleagues elaborate the topic of how to reflect on the basis of China's traditional industrialization the significances of its new industrialization in the article titled "Why should China take a new road of industrialization."<sup>9</sup> I do not want to repeat them here again but would like to stress two points. First, China's traditional industrialization was carried out under the system of planned economy, which is highly concentrated, while its new industrialization has been pushed forward under the system of socialist market economy. China has successfully built up an initial framework for its socialist market economy system over the past two decades, and with gradual improvement of the framework, the advantages of China's new road of industrialization will become more and more obvious. Second, the capital needed for the development of China's traditional industrialization mainly came from agriculture and farmers. In other words, a great amount of capital was accumulated by collecting the agricultural tax and from the price gap between agricultural and industrial products. Moreover, one of the historical missions of industrialization is to transfer a large number of farmers to the primary and secondary industries, however China drove numbers of city residents to rural areas to engage in agriculture at hard times during the period of its traditional industrialization. As a result, rural areas and agriculture in China had become more and more slack. China's new industrialization, in contrast, encompasses the historical mission of transforming the dual economy into the modern one. To achieve the goal, China has made great efforts in turning a great number of farmers into urban residents through industrialization and urbanization. In addition, China has been following a long-term guideline of animating domestic demands to enlarge market space for its new industrialization. Great efforts have been made to raise continuously farmers' income, expand the domestic market and turn the enormous domestic market potential into reality.

Although China has to overcome the serious defects of the traditional industrialization to push forward its new industrialization,

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<sup>9</sup> *Economic Daily*, Feb. 19, 2003.

we should be aware that it was not easy for our forerunners to lay down an industrial foundation during the process of the traditional industrialization, which was carried out under the planned-economy system and the hard conditions such as blockade and embargo imposed on China by some western countries. More importantly, we should take hold of the present historical opportunity to push forward new industrialization, turn China's dual economy into the modern economy and achieve the aim of building China into a well-off society.

#### **CONTRIBUTION TO THE WORLD**

China's new industrialization belongs to the second round of the industrialization process in the world, which is centered on developing countries and regions. The first round of industrialization turned Britain, the United States and Japan into world factories. In recent years the international media has attached the term "a new world factory" to China. Even some domestic scholars echo the view. Most people, however, hold that China is still a far cry from a world factory, while others maintain that it should be an aim to be achieved in the future to build itself into a world factory. My viewpoint is that the present historical stage is not provided with and therefore cannot provide any country with the historical conditions that produced some world factory in the past. But China will hopefully develop from a large manufacturing power into a strong manufacturing power within the first two decades of the new century and become one of the world's manufacturing centers, so long as China insists on the strategy of pushing its new industrialization and integrating its new industrialization with the historical trend of transfer of manufacturing production base from the developed countries and regions to the developing economies.

The world economy has shown two important growth trends since the 1960s. One is that the developed countries have entered the "post-industrial society" and the information era. Their industrial structure had undergone remarkable changes. On the one hand, the high and new technology and service industries had developed rapidly. On the other hand, some labor-intensive industries (such as textile, clothing and food), highly energy-consuming, highly material-consuming and highly

polluting industries had gradually declined. Some of them became sunset industries, and many enterprises in these industries, especially the general manufacturing industry, transferred their production lines to other countries, mainly developing countries and regions. The other trend is that an industrialization process had been started worldwide, which is centered on developing countries and regions. I call this developing countries-centered industrialization the second round of industrialization of the world, or belated industrialization of the world. Those countries and regions concerned were colonies or semi-colonies over a long time in the past. Only after they achieved political independence in the 1960s after World War II did they start to push their industrialization independently. For example, in the 1970s, the so-called "Four Small Dragons" began to emerge in East Asian developing regions. They were called the newly industrialized economies (NIEs). Following that, the ASEAN and China resorted to industrialization to realize economic lift-off. What is noteworthy is that the industrialization process of East Asian developing countries and regions is in tandem with the industrial transfer (mainly manufacturing transfer) of some developed countries to that region. Some manufacturing industries that have gradually lost advantages were first transferred from the United States and Japan to the "Four Small Dragons" and then from the "Four Small Dragons" to ASEAN and China. In the 1960s to 1970s, the transfer was that of textile and garments; in the 1980s, it was that of household electric appliances and the chemical industry. Since the early 1990s, Japan has slowed down its investment momentum in East Asia while the United States has rapidly increased its investment in this area, especially in the processing of components and assembling in high-tech industries such as the information industry. It is the incorporation of the independent industrialization process of developing countries and regions with the manufacturing transfer from developed regions that makes it possible to produce a regional or global manufacturing base or center like the East Asian region. However, it is the high-tech industry instead of the manufacturing industry that represents the highest technological level nowadays. The global manufacturing bases or centers coming out of the second round of global industrialization process have lost their glamour of being the

traditional world factory. In terms of technological and economic levels, they remain a far cry from those major developed countries that monopolize high-tech industries.

The manufacturing industry in the developing countries and regions has developed rapidly during the process of the belated industrialization. But not all countries that push industrialization can be developed into world-class manufacturing bases or centers. It has been proven by the fact that only some of the dozens of industrialized countries became the world factory in history. In my view, China may lead other countries to become a new world-class manufacturing base (or center) in the first two to three decades of this century. It is because China has some advantages that other countries do not possess. First, China has become the fourth largest manufacturing power of the world and the scale of its manufacturing industry is the largest among all developing countries. Second, China is a major trader, being the sixth largest trading body of the world. It also has the advantage of a vast domestic market supported the manufacturing industry. Third, it has become the country with most foreign investment inflows in recent years. In 2002, it attracted more foreign investment than the United States. Fourth, it possesses a fairly advanced industrial infrastructure (such as electric power, transportation and communications). Fifth, it has established a comprehensive industrial production system that encompasses some high technologies. Although its technological basis is rather weak, the industry has a fairly capable supporting and complementary system. Sixth, it has low labor costs and plenty of high-caliber human resources. There are up to 1 million graduates of science every year and more than 400,000 returning graduates from overseas. Seventh, it is blessed with a marvelous geographical space ranging from the coastal areas to the western areas that can provide enormous space for the extending development of the manufacturing industry. Eighth, the most important advantage is that "a new road of industrialization," which is pointed out at the report delivered on the opening day of the Chinese Communist Party's 16<sup>th</sup> National Congress, is a reliable guarantee for us to fulfill smoothly the historical mission of realizing industrialization. The above-mentioned advantages China enjoys,

together with the trend of the manufacturing transfer from developed countries and regions to developing economies, will definitely provide great historical opportunities for China's growth into a world-class manufacturing base, which is one of the centers of industrial technology development, processing and manufacturing, and manufactured product import at the same time. To realize the goal within the early stage of this century, China should bring out fully the internal and external favorable conditions under the leadership of Chinese Communist Party. This is also the route to realize the goal of building China into a well-off society in an all-round way. These goals will be realized at the same time when China fulfills its historical mission of industrialization. Provided with a great historical opportunity, China should make every effort to fulfill the holy mission of realizing the goals.

The majority of the international community has made positive comments about and have high expectations for the prospect of China's economic development, but a small number of people have been airing "China's threat," For example, some Americans say that "China has a great stock of very cheap laborers that poses a threat to the benefits of the U.S. laborers" and "the American manufacturing industry will be destroyed by China." Fortunately there are a great number of righteous people in the United States, and a journalist named Daniel Oltermann [translated according to the pronunciation] is one of them. In his article entitled "Is China a Partner or Adversary," which was published in *The New York Times* on March 21, 2003, he criticized those comments about "China's threat" as alarming. He pointed out that U.S. enterprises follow the market laws in transferring their production lines to China, and "they have to do so to keep their competitive edge." He said that it is natural for U.S. enterprises to compete with enterprises from Japan, Taiwan and Korea for China's low-cost human resources after seeing them invest in China one after another. Mr. Oltermann further pointed out that China's economic development has given an impetus to the American transition from a manufacturing industry-dominated economy to a service industry-dominated economy. At present the total number of laborers in the manufacturing industry in the United States has fallen down to only 16 million, almost tantamount to the

figure in 1950s, while the number of laborers in the service sector has risen from about 30 million to 107 million over the past 50 years. These figures show that the U.S. industries have not seen the phenomenon of becoming hollow. Instead they are going through the economic transition. As the chief economist of the U.S. National Association of Manufacturers said, "China is giving a boost to American structural transformation." Moreover, the United States imports large quantities of cheap and quality products from China every year, which are of great benefits to its consumers. According to a report on the world economy released in 1997, the inflation rate in the United States may go up 2 percent without import of those cheap and quality products from China. It indicates that China can share its advantage in human resources with other countries under the condition of economic globalization, and this is one of the significant contributions China has made to the world.

China's advantage in human resources, in other words, its low labor cost, is in essence due to its backward economy. Chinese people, especially farmers, are very poor. Although China quadrupled its GDP over the last two decades of last century, its per capita GDP was only US \$850, behind the 100<sup>th</sup> country in the world. Moreover, there were still 30 million poverty-stricken people in China's rural areas by 2000, who were still plagued by lack of food and clothes. Even when China's per capita GDP reached US \$1000 in 2002, the number of poverty-stricken farmers still stood at 28 million. The reasons why China is pushing forward new industrialization are to build its dual economy into the modern one and allow the farmers to build, together with the other Chinese people, the well-off society in an all-round way. It is estimated that China's population will reach 1.4 billion by 2020 and its per capita GDP will rise to US \$3000. Though this figure is only tantamount to the level of a country with middle income, it is of great significance to the world. Poverty is prone to lead to convulsion. It will constitute an important factor for world stability and peace that Chinese people, accounting for one quarter of the world population, live

a better life. This will be the greatest contribution China will make to Asia and the world as a whole. Chinese people will feel proud for it and work hard for it.



REMARKS ON HUANG FANZHANG'S PAPER ENTITLED "ANALYSIS OF CHINA'S NEW PATH  
OF INDUSTRIALIZATION FROM A GLOBAL PERSPECTIVE"  
BY JOHN DESPRES

Huang Fanzhang's paper is a lucid and authoritative explanation of the CCP's general goals and principles to achieve a society that is progressively better off. It also describes key aspects of China's international economic situation, relatively abundant labor supply, continuing technological backwardness, persistent poverty, tendency toward social convulsions, and economic vulnerability to misguided protectionism in developed countries, notably the U.S.

In addition to outlining China's large and growing role in international industrial investment and trade, the paper elaborates on the Communist Party's current policy to pursue a new path, which is neither a "planned economy" nor a repetition of the way more advanced countries industrialized but rather a "socialist market economy" that takes advantage of new technological and market possibilities and avoids other countries' mistakes.

The paper cites industrialization as China's "historical mission," which the CCP's most recent National Congress endorsed along with "informatization." Although it was not defined in detail, "informatization" is seen as a way to push industrialization while industrialization is, in turn, seen as a way to promote "informatization," thus enabling China to shrink its technological lag behind developed countries. Indeed, the paper argues that China's new opportunities to use modern information technology, which can enhance the economic benefits and lower the material, environmental, and high-quality human resource costs of industrialization, are its main advantage as an industrial latecomer.

The paper also cites another advantage as a latecomer which also derives largely from outside China, namely its ability to combine "surplus capital and technologies from the developed countries and regions with ... rich human resources ... to accelerate its economic development." Yet another potential advantage for China as a latecomer is to avoid the past mistakes of "plundering natural resources, first

polluting, then improving the environment" and by seeking a "new and sustainable way of development ... [with] low resource consumption and less ... pollution."

In short, the paper highlights a few new historical opportunities for China to build a better society by industrializing, urbanizing, and modernizing its "dual economy" more quickly, efficiently, and cleanly than it and others have done in the past. While these goals are highly laudable and probably technologically feasible, the paper barely sketches how they may be achievable in practice and what reforms are needed to realize them.

For example, it offers estimates of rural unemployment in 2000 of 142 million redundant laborers, or 42.45% of the total, and projections of a similar number of rural laborers migrating to cities by 2020. But it does not explain why such massive migration and urbanization may be necessary, much less desirable, if new information technologies, whose economic value it stresses, creates greater than expected economic opportunities in the countryside, accelerates the growth of rural productivity, and shrinks rural-urban income gaps in the next decade or two.

Nor does it have much to say about the wide variety of economic institutional reforms and other policy initiatives that will be needed to sustain China's high rates of growth. Indeed, it does not even mention the importance of China's challenges to comply with the WTO, which are not only essential to keeping global markets open to China's exports but would also improve China's competitiveness and productivity.

In urging that China improve its independent R&D capacity, it ignores the importance of strengthening China's legal regime to protect patents and copyrights, which is needed to stimulate market-oriented investment in technological research, development, and innovation by both Chinese and foreign enterprises. Moreover, it just asserts but does not make an economic justification for a greater, independent R&D capacity, beyond what is justified for national defense. While it could make more valuable contributions to global scientific knowledge, it could also spend vast and scarce, high-quality technical resources in ways that add less to than they subtract from China's economic capacity. Rather than learn from future mistakes of its own, China would be well

advised to heed the lessons from the excesses of others in pursuing the very best technology when less costly and sophisticated methods solve problems effectively enough, and often more efficiently.

Finally, while correctly citing the mistakes of other countries in unduly discounting environmental damage, with the benefit of hindsight, it neglects other mistakes they have made which China is likely to remain at risk of repeating, e.g., Japan's doing too little, too late to create a more competitive banking system and capital markets. Needless to say, it's much harder for insiders, like the author, to admit than it is for outsiders, like us, to warn of the dangers of deferring major institutional reforms that may only be needed to sustain longer-term growth but that would certainly be costly or painful in the near term.

Bottom line: too much Karl Marx (and technological *dirigisme*) and not enough Adam Smith (and market mechanisms) .



**"BASHING CHINA BY CLUBBING MULTINATIONAL CORPORATIONS"**

**BY GARY CLYDE HUFBAUER AND DANIEL H. ROSEN<sup>1</sup>**

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**INTRODUCTION**

China has participated in economic globalization over the past two decades, and now no longer just follows the story but ranks among the lead drivers. The impact of Chinese expansion is felt throughout Asia, North America and Europe. U.S. merchandise imports from China have reached \$125 billion a year, equal to 1.2 percent of U.S. GDP, highly concentrated in manufactured consumer goods. Chinese exports are about 60 percent of what the United States bought from Canada or the European Union in 2002, and almost as much as the United States imported from Mexico (at \$135 billion), and more than the United States imported from Japan (at \$121 billion). These are impressive figures for an exporting nation that practiced autarky in the 1970s. Moreover, the total of China's merchandise imports and exports (which are about in balance) amount to around half of China's own gross domestic product (measured at the market exchange rate of RMB 8.3 to the dollar). This is another indication that China has become "internationalized," though to a lesser extent than Mexico or South Korea.

Multinational corporations (MNCs) have contributed enormously to China's internationalization, and today account for an estimated 50 percent of China's trade.<sup>2</sup> Many of the MNCs involved in China derive a hefty share of their global sales growth from Chinese economic development. Automobile sales in China (passenger cars only) more than doubled year-on-year for the January-June period this year. Since car ownership in China is under 3 percent, there is a lot of market yet to serve. Competitive benefits to MNCs from their Chinese operations are,

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<sup>1</sup> The opinions expressed do not represent the views of the Institute for International Economics, its director, fellows, or board members.

<sup>2</sup> China's welcome mat for MNCs differs from the development path successfully traveled by Japan and South Korea - national champion firms, with little foreign participation.

in some cases, strategically significant. Wal-Mart buys more than \$10 billion worth of goods (wholesale!) in China today, defining large segments of its price structure. The savings enjoyed by one global automation equipment firm from sourcing in China amount to 6 percent of its global revenues--enough to get Wall Street's attention. As many as 400 MNCs (half of them U.S. firms) have established R&D centers in China in recent years to take advantage of impressive engineers delighted to work for about \$4500 a year (enough to live in Shanghai or Beijing).

This familiar story may seem like economic sunshine in China but it sounds like warning thunder in other parts of the world. Japanese pundits blame China for their woes, even including deflation. U.S. manufacturing firms confront Chinese competition at every turn, not only in consumer goods but also in electronic components and light machinery. Textile and clothing firms everywhere fear the Chinese onslaught once the Multi-Fiber Agreement (MFA) expires.

#### **MNCs IN THE CROSS HAIRS**

Putting these two themes together--rising protection sentiment directed against China and increasingly integrated MNC operations with a base in China--it appears that multinational firms are targets ripe for attack. Many countries seem poised for a replay of the "run-away plant" hysteria that swept America in the wake of Japanese export successes in the 1970s and 1980s. Inside the Washington beltway, we remember Clyde Prestowitz's *Trading Places* and Lester Thurow's *Head to Head*. How long before the Chinese sequel reaches print? From a European perspective, how long before INSEAD students are reading a new best seller titled *Le Défi Chinois*? Japanese, Taiwanese, Korean, Mexican and Brazilian policymakers are likewise training their sights on Chinese manufacturing as the source of economic woes. Such is the international policy payoff, for China, of two decades of hard-fought economic reforms.

Various remedies are being explored to curb Chinese competition. Accompanying the remedies are diagnoses ranging from aggressive Chinese salesmanship that follows the rules of comparative advantage, to reprehensible practices that exploit workers and mother earth.

World Trade Organization (WTO) members can protect themselves against Chinese exports using the full range of remedies. They can

block Chinese exports by invoking special safeguards acquiesced to by China when it entered the WTO. They can use non-market economy methodologies in judging anti-dumping (AD) margins, and they have wide discretion to impose sanitary/phyto-sanitary (SPS) trade impediments and technical barriers to trade (TBTs).

Outside the WTO framework, G-8 members (initially led by Japan in an effort to explain 12 years of stagnation) have made the foreign exchange value of China's currency--the *Renminbi* (RMB) or *Yuan*--a *casus belli* in their trade protection campaigns. U.S. Senator Charles Schumer (D-NY) has called China's currency peg of 8.3 against the U.S. dollar "illegal." Less passionate critics claim that the RMB is 20 to 25 percent undervalued.<sup>3</sup> Whatever the merits of these claims, it is significant that they are voiced most energetically not by Chinese economists worried about an overheated domestic economy but by foreign countries that feel the hot breath of Chinese trade competition.

Whatever safeguard or AD measures might be slapped on Chinese exports, and whether or not China revalues the RMB, perhaps most threatening are attacks that might be leveled against multinational companies, rather than attacks on Chinese trade and monetary policies.

In 2003, MNCs will likely invest \$60 billion in China in the form of new foreign direct investment (FDI); they will spend over \$100 billion sourcing from Chinese vendors; and they will ship roughly half of China's \$325 billion annual exports. For all its fabled low-cost labor, China still depends on foreign distribution and marketing power to earn its share of the global value added chain, and it will remain dependent for years to come. In other words, China has much to lose if external pressures dampen the ardor of MNCs.

MNCs have much to lose as well. At risk are the cost savings achieved by shifting procurement to China (30 to 60 percent savings seem to be the norm) and the market shares painstakingly acquired through years of "paying tuition" (as expatriate managers selling in China like to say). Valuable as these benefits are, more valuable still to an MNC is its global reputation as a good corporate citizen. For firms selling

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<sup>3</sup> For example, C. Fred Bergsten and Morris Goldstein at the Institute for International Economics.

consumer brand products, such as Nike and Gap, reputation is critical. But even for purely industrial firms, such as Caterpillar or United Technologies, reputation affects Wall Street valuations and business contracts.

MNCs doing business in China are sometimes accused of exploiting low social standards.<sup>4</sup> When such charges stick, they can damage a firm's reputation among affluent consumers and soccer moms from Palo Alto to Paris. To assess this threat, we first look at efforts to play the "bad corporate citizen" card against foreign firms operating in China, and note the potential application of an obscure U.S. law known as the Alien Tort Statute of 1789 (ATS). We contrast these adverse characterizations and potential lawsuits with a review of the efforts of some MNCs to conduct their affairs in a progressive manner. Finally, we offer a few forward-looking observations.

#### **BRING ON THE ARTILLERY!**

Activists espousing social causes have imaginative strategies for pressuring China. Much of the activism is in earnest. Some of it is veiled protectionism. When industrial unions speak the rhetoric of green environmentalists, the underlying motives are clear. On other occasions, the motives are harder to discern. But we are not so much concerned with motives as with methods and consequences. Among the channels used by activists are boycotts, codes of conduct, and prospectively the U.S. court system.

#### **Boycotts**

A search of "boycott China" on google.com brings up 104,000 hits. The top return is a website called "Boycott Made in China: Free Tibet." The organizers contend that China is teetering on the edge of economic collapse, and thus a boycott by rich world consumers (who may each buy \$1000 of made-in-China goods a year, according to the site) can help

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<sup>4</sup> See, for example, the UAW website on China at <http://www.uaw.org/cap/01/issue/issue15-3.html>. It says, in part: "As China's economy grows and its integration with the global economy increases, the impact on the U.S. and other countries of China's repression of workers' rights becomes a more pressing problem."

push China over the edge and stop the migration of business firms. The site claims: "[P]rofit margins are thin and China manages to beat out competitors primarily because of its ruthless exploitation of labor. In spite of brutal repression by the state, labor-related riots and violence are increasing all over China." The argument is that Chinese leaders will have to improve social conditions to avert a collapse. If leaders don't mend their ways, a boycott could precipitate a crisis and put an end to China's competitive strength.

Boycotts have been directed for years at U.S. firms doing business in China. A recent web search turned up boycotts aimed at Dell Computer, Hasbro Toys, Sunbeam, Wards, Toys R Us, JC Penney, Wal-Mart, Kmart, Sears, Costco, Rite Aid, Target, Dillards, Sam's Club, America Online, Safeway, Pier 1, Play School, Mattel, Dr. Scholl's, Home Depot, Lucas Arts (because Star Wars action figures are made in China), Liz Claiborne, and Esprit. A common allegation is the use of slave or child labor. A common characteristic of MNCs subject to boycotts is their recognizable brand names.

While the number of MNCs targeted seems to have grown dramatically, the collective number of boycotts may have watered down their individual effectiveness. But China and its MNC friends should not be complacent. Under the "right" conditions, the current gaggle of company-specific boycotts could merge under a "Boycott Big Business, Boycott China" banner.

#### **Codes of Conduct**

Another channel of activism, from the corporate social responsibility camp, centers on making MNCs accountable for their interactions in China. Preferred tools are external social audits, managers tasked with meeting social standards, and pension fund investment policy based on corporate citizenship. This approach naturally leads to corporate codes of conduct as a tool for guiding MNC behavior.

Many different model codes are in circulation today, urged on MNCs doing business in China and other developing countries. These range in focus from human rights and labor and environmental standards, to more general democratization, to business ethics including detailed steps to

curtail bribery and corruption. To have an effect (as opposed to window-dressing) the code must complement the company's core values. Business for Social Responsibility, a group dedicated to business ethics and values, lists five major templates that are relevant for developing a corporate code, in addition to the firm's own mission statement:

- Global Reporting Initiative
- The United Nations Universal Declaration of Human Rights
- The Global Sullivan Principles of Social Responsibility
- The OECD Guidelines for Multinational Enterprises
- UN Global Compact

These statements enumerate worthy goals and identify useful implementation steps. However in China today there is little consensus among foreign managers about which of these (or what combination) would make an appropriate code of conduct. After all, China is not a monolithic place. There are few sweatshop labor issues for Flextronics or Solelectron, multi-million-dollar investors in capital-intensive industries with brand new, state of the art factories. MNCs based in urban centers don't incline to sweatshop operations because wages are already high and rising and productivity matters more than cheap help. In the hinterlands, however, things are different. Producing garments or toys in rural Sichuan may only be profitable at the margin of acceptable labor practices. Similar differences characterize environmental and political practices in different regions of China. A single code of conduct for all of China is hard to envisage because the range of Chinese social norms is so vast.

A study by our colleagues Kimberly Elliott and Richard Freeman, entitled *Can Labor Standards Improve under Globalization?* cites the example of a former political prisoner in China named Han Dongfang. Dongfang now advocates labor reforms in China from a Hong Kong base. According to Elliott and Freeman: "He also notes that workers filing lawsuits for labor law violations against American and other foreign-owned companies may have the best chance because they can invoke the theme of unfair exploitation by foreigners in their behalf (*American Educator*, Winter 2002, p. 43). The U.S. Congressional-Executive Commission on China also recommended increased U.S. government financial

and technical support for training of labor lawyers and others to help Chinese workers use the law to protect their interests." This brings us to the awakening monster that is the Alien Tort Statute of 1789.

**Alien Tort Statute of 1789.**<sup>5</sup> The Alien Tort Statute (ATS), dating from the early days of the republic, is a very short law. It states: "The district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States."

The ATS was little used for nearly 200 years. Beginning in the 1980s, however, the statute has been invoked in several class action lawsuits brought in US federal courts by *foreign* (alien) plaintiffs for alleged wrongs that occurred *outside* U.S. territory. As of 2003, ATS plaintiffs have sued more than 50 multinational corporations doing business in developing countries, alleging more than \$200 billion in actual and punitive damages.

While U.S. circuit courts have yet to pass final judgment in a corporate case, firms doing business in countries that account for 5 billion people (including India and China) and half the world economy are potential targets. The following scenario is entirely plausible within the next decade. Some 100,000 class action Chinese plaintiffs, organized by New York trial lawyers, could sue General Electric, Toyota and a host of other blue-chip corporations in a U.S. federal court for abetting China's denial of political rights, for observing China's restrictions on trade unions, and for impairing the Chinese environment. These plaintiffs might claim actual damages of \$6 billion and punitive damages of \$20 billion. To settle the case, firms might compromise on an award of \$10 billion. Thereafter they would cast a wary eye on operations in China.

Such blockbuster cases are already working their way through federal and state court systems. In another decade, ATS awards and settlements could rival asbestos both in size and collateral damage, where awards already exceed \$50 billion, and legislation working through Congress envisages a fund of around \$150 billion to resolve outstanding claims.

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<sup>5</sup> See Hufbauer and Mitrokostas (2003).

After twenty years of expansive judicial rulings, federal district courts and two circuit courts have held that corporations may be held liable under the ATS:<sup>6</sup>

- For violating treaty norms, even when the treaty in question was not ratified by the US Senate;
- For violating the "law of nations" as contemporaneously interpreted by the trial court;
- When either the corporation or its employees commit the violation; or
- When the corporation is found to aid and abet its host government or act under color of law.

Cases now in court allege a variety of wrongs. They range from "classic" violations of international law--slavery, war crimes and torture--to contemporaneous offenses such as forcible displacement, religious persecution, environmental pollution, and pharmaceutical testing. The growing wave of litigation threatens to turn U.S. federal courts into agents of judicial imperialism. This development carries several hazards:

- U.S. court decisions will conflict with jurisdictional claims of other states, particularly when plaintiffs and defendants are both foreign;
- They will inflame relations with foreign states that are home to multinational firms hit with ATS suits;
- ATS class action awards will create another attorney-driven enrichment machine; and
- Court decisions will interfere with the separation of powers: the executive branch is responsible for U.S. foreign affairs under the Constitution.

Many developing countries are potential targets of ATS litigation because firms conducting trade with, or investing in, those countries

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<sup>6</sup> Judges in the Circuit Court for the District of Columbia have held that the ATS confers jurisdiction only over violations recognized in 1789 plus those subsequently enumerated by Congress. The Justice Department has put forward the same interpretation in its *amicus* brief to the Ninth Circuit in the *Unocal* case. This view, currently a minority position, may eventually prevail. For now, federal district courts are letting expansive ATS claims go to discovery and trial.

will be sued. The "at risk" category includes virtually all countries with unsatisfactory records--measured against contemporary American standards--for political rights, civil liberties, economic freedom and corruption. These nations have a combined population of about 5 billion persons (including India and China) and a combined GDP of around \$18 trillion.

To summarize, while these are early days for ATS litigation, future cases could certainly disrupt MNC operations in developing countries, especially in China. The potential damage is not limited to U.S.-based MNCs. Any MNC (including Chinese firms) with economic contacts in the United States could end up as an ATS defendant.

#### **ASSESSMENT**

Two ironies surround the current campaign against MNCs for their activities in China. First, the foreign enterprise-oriented system that China has nourished over the past twenty years has massively reduced poverty on a scale never before seen. Between 1990 and 1999 alone, poverty in China fell by 41 percent as a result of reform and heavy MNC involvement. So while social activists are right when they routinely point out that 25-30 million state sector employees were laid off in the 1990s, they conveniently ignore the fact that more than 154 million Chinese were lifted out of poverty during this decade. (Over the entire reform period since 1979 the number is well over 200 million, as the World Bank likes to point out.)<sup>7</sup>

The economic growth behind poverty reduction was broad-based in China. While inequality rose in China (everyone started equal--equally poor, quite seriously), in absolute terms incomes have risen in all income quintiles, though in relative terms the wealthier urban residents did better. Even in the rural agrarian sector, growth and productivity have been superior to most other developing countries.

The second irony is that MNCs targeted by boycotts, codes of conduct, and ATS lawsuits are generally far removed from socially

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<sup>7</sup> Despite intense restrictions on MNCs and a highly regulated economy, India also saw poverty reduction during the 1990s, but by a much smaller 4.5 percent, or 18 million Indians. For a general analysis, see Bhalla (2003).

reprehensible conduct. But MNCs make easy targets, both in the court of public opinion and the court of law--and for activists that's enough. On occasion, a Wal-Mart, General Motors or AIG may pollute the water, require illegal overtime work, or pay bribes. But those are exceptional transgressions. For the most part, big firms pay wages well above the local norms and provide much better working conditions. They also pay taxes, unlike many other companies. Thus they provide the resources for useful Chinese government programs (building schools, hospitals, and sewers; paving roads; and funding pensions). Arguably, they also help maintain the government in power. Well-meaning activists as well as right-wing hawks may think that a government collapse would be good for Chinese society. We disagree.

In any event, atrocious social conditions in a giant developing country like China are found, in rough order from worst to best, in the following settings:

- Unemployed urban poor with no agricultural fall-back;
- Unskilled workers in state-dominated extractive industries or Chinese private companies that subcontract to them;
- Domestic sweatshop firms not affiliated with an MNC and hence under no pressure to raise standards;
- Sweatshop firms owned or managed by Taiwanese, Hong Kong or other managers from regional cultures able to sidestep local laws;
- Suppliers at arms length to MNCs;
- Finally, MNCs themselves and their alliance partners.

The targets of social activism are thus, quite often, the most progressive operators. Their role as "bad guy" reflects three facts: they have brand names, they are easily reached by Western regulatory and legal initiatives, and they have deep pockets.

The Business Roundtable, in a report entitled *Corporate Social Responsibility in China: Practices by U.S. Companies*, summarizes the practices applied by U.S.-based MNCs based in China. The practices are grouped into eight categories, of which codes of conduct are only one:

- Ethical and responsible business behavior;
- Corporate codes of conduct;
- New ideas and information technology;
- Western business practices;
- Environmental, energy efficiency, health, and safety standards;
- Compensation, benefits, and training;
- Volunteerism, charitable giving, and community activism; and
- Rule of law.

For reasons of profitability, habit, self-protection, and values, U.S. Fortune 500 firms operating in China today (and almost all of them are) generally abide by sound practices in each of these areas. Their efforts are not perfect. Sometimes the MNC itself is at fault. More often, Chinese regulatory and cultural impediments are the barrier. For example, the MNC might want to lay off some employees with severance and provide better training for the remaining workforce. China's employment laws may limit the firm's ability to make these changes.

#### **CONCLUSIONS AND RECOMMENDATIONS**

The trial of MNCs in China both in the court of public opinion and in the law courts is here to stay. Based just on social conditions, the continued steep improvement in Chinese livelihoods ought to portend a softening of boycott campaigns and creative litigation. While a freer press means more frequent stories of abusive labor conditions, social unrest in older industrial cities, and corrupt officials, a more accurate picture of China would temper the flow of tabloid hyperbole about "vicious slave labor exploitation" and similar characterizations.

But U.S. activism is not solely based on social empathy; it also has an economic protection element. And that component will grow, not decrease, as long as China's reforms induce structural adjustment and industrial growth at a quicker pace than other major economies. This "policy wedge" is the ultimate source, for example, of the Mexican uproar over the Chinese "theft" of maquiladora factories.<sup>8</sup>

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<sup>8</sup> See Rosen (2003).

Economists and academics may appreciate the connection between faster policy reform and growing exports from China, but courts hearing ATS cases, activists marshalling their constituencies, and journalists writing on the *Renminbi* do not. What, therefore, could be done to mitigate public clamoring for aggressive actions toward China?

First, clear and principled leadership from the U.S. executive branch plays a very large role in setting the tone for U.S. thinking. Over the spring of 2003, currency speculators and uncompetitive U.S. industries tried to make public opinion think that the RMB--pegged at 8.3 to the U.S. dollar for many years--was being actively "manipulated" to the detriment of U.S. jobs. But only when Treasury Secretary John Snow jumped in with the accusers did leading American started believing the China was playing unfair with its exchange rate. Nuances--the fact that China is in trade balance on a global basis, and the fact that China needs a large pool of foreign exchange as insurance against a weak banking system and financial crisis--were ignored. There may be a principled case for China to revalue against the dollar, along with other Asian countries, but demonizing China as a "currency manipulator" is not a useful part of argument. While Senator Charles Schumer can make such statements, the Secretary of the Treasury should not.

Second, there is room for a leader in the activist community to step forward with a new emphasis. A group that acknowledged the humanitarian gains of China and its MNC-friendly model over the past 20 years, while redirecting public ire against unknown firms that cut corners on standards in relative obscurity, would deserve widespread support. This would be harder to organize than a boycott or lawsuit against Nike, but it would be more likely to do good--especially if Chinese consumers were part of the campaign.

Third, the G-8 countries need to empower an international organization to champion social concerns in the marketplace. The International Labor Organization (ILO), rather than the World Trade Organization (WTO), is the right shop for that job. In 2000, the ILO found Myanmar to have used coercive labor practices that were clearly forbidden, and invited all members to take appropriate steps--such as trade sanctions--to penalize Myanmar. At the time the State Department was enthusiastic about talks underway with Aung Sung Suu Kyi, and

opposed a fresh round of economic sanctions (Washington sentiment has since turned against the Burmese generals). In retrospect, the ILO initiative in 2000 presented a golden opportunity to use the right tool for the right job and set a precedent that might divert activist attention away from boycotts and litigation.

Fourth, China can take its own steps to discourage mindless campaigns against MNCs. China can systematically survey employment, wages, working conditions, and environmental practices in MNCs (distinguished by home country), and publish the results on a timely basis. China can improve its court system, so that legitimate claims by employees and villagers adversely affected by industrial development are adjudicated on a timely basis. China can liberalize imports, slashing its own tariff and non-tariff barriers well ahead of lengthy WTO negotiations. Free trade is a powerful defense against protectionist sentiment in the North America and Europe. It is also a potent stimulus for Chinese growth.<sup>9</sup> Finally, in negotiations with the United States, China should insist on the principle that China has original jurisdiction for tort claims brought by Chinese residents against MNCs for injuries occurring in China.

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<sup>9</sup> Recall Abba Lerner's famous theorem that import tariffs are equivalent to export taxes.

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DINNER SPEECH AT 6<sup>TH</sup> ANNUAL RAND-CHINA REFORM FORUM CONFERENCE  
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BY DR. HAROLD BROWN

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**DEALING WITH THE NORTH KOREAN NUCLEAR PROGRAM**

Dealing with the North Korean Nuclear Program has the following characteristics. It is the issue with the highest risk during the next couple of years of resulting in a full-scale war involving hundreds of thousands of casualties. If not handled properly, it could poison U.S.-PRC relations for decades--the last such case, the Korean War, created such a situation that lasted for two decades until 1972, before the effects began to be reversed. On the other hand, if jointly managed properly by the U.S. and the PRC, it could set a course for stable, peaceful, prosperous evolution in Northeast Asia.

All parties (the U.S., the PRC, Japan, Russia, the Republic of Korea) except North Korea (the DPRK) agree that the Korean peninsula should be free of nuclear weapons. The U.S. withdrew its nuclear weapons years ago. Many of the parties use the same language but don't necessarily mean the same thing. All the others tend to call North Korean nuclear weapons "unacceptable," but many of them mean instead distasteful, dangerous, or troublesome. Unacceptable implies a willingness to take whatever steps are necessary to prevent such a situation from occurring or persisting.

Of the various countries I've mentioned, as of now the Republic of Korea seems least concerned about North Korean nuclear weapons. Perhaps its reasons are understandable--South Korea is menaced more by North Korean conventional capabilities than by its potential nuclear capability. And a new generation of South Koreans can't be expected to be highly aware of a war that was fought fifty years ago; they tend to emphasize the single national identity of North and South Korea and are either unaware of or minimize the differences between the two societies. The Russians are relatively detached from the issue of North Korean nuclear weapons, but the Japanese are very worried. The U.S. has

resolved to reverse that program, but there are significant differences even within the Bush administration as to how to go about that.

The PRC is apparently very much against the North Korean nuclear capability. Indeed it should be, because a nuclear North Korea makes a nuclear Japan a strong possibility, as well as increasing the odds of a nuclear South Korea or even a nuclear Taiwan. But it is not clear how determined the PRC is to take active measures to prevent a fully developed North Korean capability.

Looking at these various national attitudes, the process for dealing with the North Korean nuclear program is not agreed, even among those that are most concerned and most determined to do something about it.

The fundamental question is whether the DPRK is determined to have some (one or two, ten, or a hundred) nuclear weapons, whether the purpose of such a stockpile would be to deter or to threaten others, or to sell nuclear weapons. The specific issue is whether the DPRK is determined to have such a capability no matter what others offer (or threaten) to dissuade it. I don't think that anyone outside of North Korea has in any real sense the answer to that question, though the PRC is more likely to have a better sense of the answer than the rest of us. It may be that even the North Korean leaders themselves are not sure of the answer. The only way to get a clearer answer is through engaging the DPRK in talks, the preliminaries to which have several times taken place, though real discussions have not.

The collapse of the agreed framework that was negotiated in the mid-1990s indicates that partial or temporizing approaches are unstable. The "more for more" approach is the appropriate one. For the DPRK, the potential benefits from such an approach would include economic assistance in such forms as food, fuel, investment, and power-generating and transmission equipment. They would also include political recognition and assurances against unprovoked military attack. What the DPRK would give in return would include the dismantling of existing programs to produce fissile material (plutonium and U235); destruction of existing nuclear weapons; verification arrangements to assure no revival of such a program. My own view is that some of the other issues, specifically those dealing with conventional forces, should be

left for a later and separate set of talks. Presumably they would involve actions on both sides to include reduced military presence near the DMZ, missile limitations, and confidence-building measures.

To put it mildly, none of this will be easy. North Korea clearly violated and cheated on the agreed framework; in turn, it considers that the US, the ROK and Japan failed to deliver on their obligations under that framework. And US action in Iraq has heightened North Korean concerns that the U.S. might at some point come after it as the next regime listed as belonging to the "axis of evil." So there is no trust on either side. And verification of the state of nuclear programs is not easy. One example is the underestimate of the Iraqi nuclear program before the first Gulf War; another example is the overestimate of the Iraqi nuclear program before the second Gulf War. And an acute problem arises immediately, because of the need to freeze North Korean programs from the beginning of talks; otherwise prolonging talks while North Korea advances its nuclear capabilities is a way for North Korea to increase its leverage.

Thus the prognosis is very uncertain. To repeat, we don't know whether there is any outcome for which North Korea would in fact be willing to give up its nuclear weapons program. Will North Korea ever give up its last nuclear weapons, including the at least one or two that we think they already have? What is a satisfactory deal? In any event, if a satisfactory deal is not reached, then "negative reinforcement" is required--and the possibility of actions along those lines must be clearly in view during discussions and negotiations. What might such negative reinforcements entail? First, an economic category exists. China, which provides a large portion of North Korean fuel and grain requirements, is key to this element. Reduction of such supplies, even cutting them off, and/or blockading North Korea's small volume of imports and exports by sea (which would be done by the U.S.) would be a way of increasing the pressure. China is understandably reluctant to engage in such tactics, in part because it involves action against an ostensibly friendly regime, which might then collapse with severe refugee problems impacting on the PRC. Alternatively, such actions could cause an explosion rather than an implosion. The same is true of military action, which is unattractive but not out of the question. Its

downside includes a high risk of massive destruction in Seoul and the possibility of hundreds of thousands of casualties from a North Korean response. Moreover, the difficulty of targeting all relevant elements of a nuclear program is real, and a land invasion risks widening the conflict.

What are the alternatives to ending the North Korean nuclear program? US deterrence of a North Korean use of nuclear weapons against the U.S. is almost surely workable-- certainly as regards a "bolt out of the blue" attack. But extended deterrence is weaker-- that is, deterrence of North Korean pressure on South Korea, nuclear threats to Japan, etc. That is why proliferation of nuclear weapons in the region is unlikely to stop with a North Korean capability; Northeast Asia is not a tension-free neighborhood. Moreover, if North Korean nuclear weapons are sold or leak out, military action against North Korea by the U.S. is likely; if then the leaked or sold weapons are used against the U.S., military action would be certain and the consequences could well extend beyond the North Korean peninsula.

A solution is possible, and even then far from certain, only if the PRC and the U.S. have a common approach to the issue. The other players are also important, but those two are the key. The European Union is not interested enough to be at the table. The Republic of Korea is ambivalent. The Russians are involved but distracted. The Japanese are vitally concerned but constrained both by history and by their own uncertainty about their security role. So it is up to the U.S. and the PRC. How both behave in this matter will play as important a role in the future relations between the U.S. and the PRC as any current issue. In my view it is even more critical to PRC-U.S. relations than the Taiwan issue, to which all sorts of peaceful outcomes are more than possible.

**"NEW ELEMENTS IN CHINA-U.S. STRATEGIC RELATIONS"**  
**BY WANG JISI**

Since the international crisis over Iraq intensified toward the end of 2002, a great part of the political world has been alarmed by, and critical of, the assertiveness and unilateralist tendency in America's international behavior. The resistance to U.S. unilateralism culminated in the French-German-Russian diplomatic coalition in the United Nations against the American-British plans for waging a war to topple the Saddam Hussein regime. In East Asia, the security situation has been overshadowed by the threatening of the use of U.S. forces to knock out possible nuclear weapons of North Korea, a traditional ally of China.

Under such circumstances, however, the China-U.S. relationship has arguably entered its best stage in history. In addition to the continued expansion of commercial ties, the political atmosphere between the two governments and societies--as reflected in the media of both nations--has remarkably improved. The military-to-military contacts have been restored, and coordinated efforts to crack down international terrorism are going on smoothly and quietly.

This "think piece" is aimed at identifying some new elements that have contributed to the improvement in China-U.S. relations today, which would otherwise have been characterized by fluctuations and crises like the Belgrade embassy bombing in 1999 and the EP-3 air collision in 2001.

**THE SHIFTING OF PRIORITIES IN U.S. FOREIGN RELATIONS AND ITS IMPLICATIONS**

In the eyes of most observers, the 9/11 attacks on the United States could not justify the war on Iraq in March 2003, especially when no weapons of mass destruction so far have been found in that country. Although it did not cost too much for the United States to bring down the Saddam regime, the occupation and "reform" of Iraq will prove to be more difficult and strenuous than earlier anticipated. The more ambitious American plans to rebuild the Arab world, for whatever purposes, will take immeasurable time, energy, and resources to implement. In addition, coping with terrorist groups of global reach, particularly preventing their attacks on the American homeland, may also

continue to be a top priority on America's political agenda and consume immense U.S. resources.

The U.S. National Security Strategy released in September 2002 declares that "the gravest danger our Nation faces lies at the crossroads of radicalism and technology." It is obvious that this perceived gravest danger first comes from extremist groups in some Muslim societies. In the foreseeable future, there is little possibility that this gravest danger would be replaced by a major conflict between the United States and any great power. In other words, China has been removed from the enemy list of the United States indefinitely.

China has also been a victim of terrorist activities, although to a much lesser extent, carried out since the 1990s by some separatists in Xinjiang and other border areas. For years, there were reports that some of the militant separatists received training in Afghanistan under Taliban. Therefore, the overthrow of the Taliban regime in 2002 was beneficial to China's security interests. Partly for economic cooperation and partly to help fight cross-border terrorism and contain Islamic extremists, the PRC has been instrumental in forming and strengthening the Shanghai Cooperation Organization, which is not aimed at competing with U.S. influence in Central Asia.

Though China was in principle against the use of force against Iraq, the quick victory for the United States and the following U.S.-led occupation of that country did not directly affect Chinese security and economic interests. Some Chinese political analysts have expressed concerns that American controls of oil fields and sea-lanes may be used as policy tools against China if U.S.-China relations deteriorate. In fact, as long as energy supplies from the Middle East, Africa, Central Asia and elsewhere are secured for China, there are few regional affairs in which Chinese and American strategic interests are in conflict with each other. Both China and the United States benefit from global stability sustained by cooperation among great powers.

#### **COMMON INTERESTS AND COORDINATION OVER THE KOREAN ISSUE**

Chinese and American security interests on the Korean Peninsula are partly congruent and partly divergent. Neither would accept a

nuclearized Korean Peninsula, and both will gain from a stable relationship between Seoul and Pyongyang. However, while Beijing emphasizes the "stability" part of the issue, Washington sets the "non-proliferation" part of the issue as its top priority.

What is encouraging for China-U.S. relations on the Korean issue is that the two governments are closely consulting each other and that each side remains sensitive to the position and interests of the other side. If the so-called "Cold War mentality" is still lingering in the bilateral relationship between Beijing and Washington, it is apparently not dominating in their mutual perceptions over the Korean issue. It is highly inconceivable that China and the United States would be engaging with each other in a second Korean War.

However, the prospects for a satisfactory solution to the North Korean nuclear issue do not look bright. The distrust between the North Korean leadership under Mr. Kim Jong Il and the Bush administration has been deepening. Can the DPRK give up its nuclear programs "completely, verifiably, and irreversibly," as demanded by the United States? Can the United States give up its plans for ensuring "regime change" in North Korea even if there were non-aggression assurances between the two sides? What would be the reaction of Seoul, Beijing, Moscow and Tokyo if there were hard evidence of the North having obtained nuclear weapons or there were a military showdown between the North Koreans and the Americans? It is urgent that China and the United States should initiate serious strategic dialogues between the two sides before a major Korean crisis is imminent.

#### **THE TAIWAN FACTOR**

Most of the time in China-U.S. relations, the Taiwan issue has been a "troublemaker." Paradoxically, the Taiwan issue today has a positive side. While U.S. arms transfer and military assistance to Taiwan continue to arouse Chinese concerns, the cross-Strait relations are relatively stable. This is mainly due to Beijing's prudence in its policy toward Taiwan. The Chinese policy pronouncements on Taiwan, though still principled, are more accommodating, and the "timetable" for an early reunification is no longer emphasized.

Recent developments have proved one more time that the Taiwan issue is circumscribed by the larger picture of the U.S.-China

relationship rather than serving as an independent variable. To be sure, no direct linkage could be established between U.S. policy toward Taiwan and U.S.-China coordination on Korea or cooperation in fighting terrorism. However, it can be argued that when U.S. strategic goals are focusing on the Middle East and the Korean Peninsula, Washington would try to maintain stability in Taiwan where no important U.S. interests are at stake.

It seems that Chen Shui-bian and his policy advisors miscalculated U.S. attitude when they decided to provoke Beijing by trying to pass a law on holding plebiscite on the island. Washington may have concluded that the Taiwan authorities had placed their political interests before the American interests, and it hardly hid its displeasure at Mr. Chen. President George W. Bush told President Hu Jintao in Evian, France, on June 3, 2003, unequivocally that his administration opposed Taiwan independence.

#### **CONSISTENCY IN CHINESE POLITICS AND POLICIES**

If the current stability in China-U.S. relations is partly owing to America's shifting foreign policy priorities, the consistency in Chinese politics and policies since the Communist Party's 16<sup>th</sup> Congress held in November 2003 has considerably contributed to the process of improvement.

The 16<sup>th</sup> Party Congress reaffirmed the description of China having entered into a "period of strategic opportunity" for the next 20 years, in which the nation will be able to concentrate on its domestic development without major turbulence in its international surroundings. While "opposing hegemonism" remains a centerpiece in China's foreign policy announcements, the real emphasis is being placed on "maintaining peace and promoting development" in world affairs, reflecting a continued moderation of China's foreign policy in general and policy toward the United States in particular.

Meanwhile, Chinese official media coverage of international events has been increasingly balanced, exemplified by the news reports on the Iraq War. The avoidance of trying to formulate or join an anti-U.S. alignment; the playing down of territorial disputes with Japan, India, and in the South China Sea; and the proposals for strengthening East

Asian regional economic integration have all demonstrated a newly gained maturity in China's diplomacy.

The consistency in Chinese domestic as well as foreign policies has convinced many international observers that China is a rising power to be reckoned with. American criticisms of China's human rights record are still heard, but they are less vocal and concentrated.

#### **MUTUAL UNDERSTANDINGS**

Despite the ups and downs in China-U.S. relations in the past few years, interactions between the two bodies politic, including cooperation between think tanks and educational institutions, have never been seriously interrupted. These interactions are giving rise to more mutual understandings between the two nations and helping reduce misperceptions and miscalculations of the policymakers. Such issues as SARS and the controversy over the revaluation of *Renminbi* are not yet over-politicized. Conspiracy theories in both countries about the other side are less popular among commentators and analysts.

After the Iraq War, the United States needs a "strategic pause" to consolidate its position in the Middle East in general and in Iraq in particular; to readjust its relations with France, Germany, and Russia; to solve its economic problems at home and abroad; and to protect its homeland from possible terrorist attacks. This "strategic pause" coincides with the Chinese definition of a "period of strategic opportunity." In the next few months and possibly during the U.S. presidential campaigns in 2004, relations with China may not be an important theme in American politics. Neither will relations with the United States likely become an emotional issue in Chinese politics, as was the case during the embassy bombing and EP-3 crises.

However, this is no time for complacency, as the recent improvement in U.S.-China relations is far from irreversible. Potential flashpoints include Taiwan, Korea, human rights, non-proliferation, and trade frictions. More fundamentally, it is still debatable in both societies with regard to whether the two nations would ultimately become adversaries because of the differences in their respective geopolitical positions, ideologies, political systems, and economic interests. More should be done to address these conceptual and practical issues.